

THE BANCO DE ESPAÑA, 1782-2017

The history of a central bank

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Pablo Martín-Aceña

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THE BANCO DE ESPAÑA, 1782-2017. THE HISTORY OF A CENTRAL BANK

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INDEX

1	Introduction	7
2	Origins: Banco de San Carlos, 1782-1829	9
3	The successor: Banco de San Fernando, 1829-1856	14
4	The Banco de España during the period of plurality of issue, 1856-1873	19
5	The Banco de España, a national financial institution, 1874-1913	27
6	A reluctant central bank and lender of last resort, 1914-1939	36
7	Under State control: from the end of the Civil War to nationalisation, 1939-1962	45
8	From nationalisation to Economic and Monetary Union, 1962-1999	51
9	The Banco de España in European Monetary Union, 1999-2017	58
10	Conclusions	66
	References	68
	Figures Index and Tables Index	71

1 Introduction

The Banco de España is one of the oldest European central banks. It was founded under the name of Banco de San Carlos in 1782, renamed Banco de San Fernando in 1829, and finally became known as the Banco de España in 1856. It was formed as a private joint-stock company which held the privilege of issuing banknotes. The Bank's charter was extended in 1856 for 25 years and renewed in 1874 for 30 years. At the same time, a decree conferred on the institution the monopoly of issue for the whole country. A new revision of the charter in 1891 extended this privilege for another 30 years. The 1921 Banking Law (partially amended in 1931), which extended the Bank's monopoly of issue until 1946, included various provisions to transform the institution into a genuine central bank, with responsibilities in the field of monetary policy and as lender of last resort. In 1946, when the exclusive privilege of issuing notes expired, the Banco de España was *de facto* nationalised and its banknotes became legal tender. It was *de jure* nationalised in 1962. Finally, in 1994, under the terms of the Maastricht Treaty of 1992, the Law of Autonomy of the Banco de España established its independence from the government and conferred full responsibility for monetary policy on the institution. Also in 1994, the Banco de España joined the European System of Central Banks.

During its first 150 years, from its foundation in 1782 to the outbreak of the civil war in 1936, the Banco de España, being a private company, enjoyed a significant degree of autonomy. Nevertheless, its role as an issuing credit institution was closely linked to the Treasury. Indeed, the Banco de San Carlos was founded to sustain the market value of the kingdom's public debt (*vales reales*) and to meet the financial needs of the Treasury, and until 1962 its survival depended on the government's will.

The members of the board of directors were appointed by the general meeting, but the government always had a royal commissioner on the board to ensure that the Bank complied with its statutes. In 1856, a governor was appointed by the Minister for Finance. Following the Banking Law of 1921, the Treasury not only appointed three board members to represent the "public interest", but also began to take a share in the Bank's profits. From the outset, the issuing limits and reserve requirements were established by government decree and any changes in the Bank's discount rates, despite falling within the competence of the board, needed the approval of a ministerial order.

Until its nationalisation, the Banco de España's paramount objective as a private joint-stock company was profit maximisation. This involved managing the Bank so as to distribute the highest possible annual dividend to the shareholders, to ensure the highest market price for its stock and to guarantee the convertibility of its notes into cash at all times. The board of directors was not overly concerned about the Bank's duties as a "central bank"; that is to say, being responsible for financial stability (lender of last resort) and monetary stability (exchange rate or price stability). The Bank's owners and board members always considered that these were the government's duties, not theirs. There was for more than a century a long-running and sometimes bitter dispute between the institution's directors and shareholders and the government (in particular, the Treasury officials). The former defended the Bank's autonomy as a private financial company, while the latter insisted on its duties as an institution with issuing privilege. The disputes reached their zenith at times of banking crises or exchange rate instability; on some occasions they were resolved in favour of the government, but on many others the Bank had the upper hand. The charter renewals were always seized by the Ministers for Finance as an opportunity to obtain concessions from the Bank, such as larger and better terms for loans and credits, interest rate reductions and a share in net profits. With each renewal, the Bank had to offer something in return.

The first charter was the only one that formally established a clear mandate for the Banco de España: to sustain the market value of the *vales reales* (the special debt issued by the Treasury to finance the continental wars at the end of the 18th century) by converting them into cash (metallic coins) at par value on request of the bearer. Neither of the ensuing charters set out well-defined objectives, such as the convertibility of notes and deposits into metal (gold or silver), Treasury financing or monetary or financial stability. If the Banco de España fulfilled some of these functions before 1939, it did so because it suited its own interests as a private credit company or because it feared that the monopoly of issue would not be renewed. The Bank thus assumed central bank policies from a sense of convenience or threat.

After 1939, this state of affairs changed. The Banco de España was placed under State control and subject to the close supervision of the Ministry of Finance. Indeed it became a mere appendix of the Treasury. Some independence was regained in the mid-1970s, after the death of Franco. The economic reforms undertaken during the political transition to democracy and the fact that it was moving closer to the European Economic Community allowed a new generation of Bank officials to transform the institution from within and to assume central bank policy objectives. From 1977, it effectively assumed responsibility for monetary policy and financial stability. In 1988 it was assigned full supervisory functions over all types of credit institutions. In 1994 it finally gained the full autonomy it had never had and was given a unique and complex mandate: price stability.

This study provides an overview of the history of the Banco de España from its foundation up to the present day. The text has been divided into periods which reflect changes in the Spanish banking legal framework, monetary regimes and domestic and world politics that affected the life of the Bank (international and civil wars, the fall of the monarchy and the proclamation of two Republics, the long Franco dictatorship, the restoration of democracy, joining the EEC-EU).¹

¹ For interested readers, a full overviews of Spanish money and banking in Malo de Molina and Martín Aceña (2012) and Tortella and García Ruiz (2013).

2 Origins: Banco de San Carlos, 1782-1829

The origins of the Banco de España date back to 1782 when it was founded under the name of Banco de San Carlos during the reign of Carlos III.¹ Like many of its forerunners, it was founded to meet the financial needs of the Treasury. It was originally the idea of Count Francisco Cabarrús, a French businessman and banker established in Madrid, who convinced the prime minister, Count Floridablanca, that a financial institution was needed to support the market value of *vales reales* (royal notes or bills), special government debt issued two years earlier to cover the military expenditure of Spain's continental wars. The Crown, unwilling to raise taxes and unable to borrow, had authorised the first issue of *vales reales* in 1780, a year after war on England was declared. The Treasury put 149.1 million *reales* into circulation, followed soon after, in 1781, by a second issue of 79.8 million, and then by a third issue of 222.9 million. Over-issue, the unfavourable course of the war and the closure of the sea lanes to Mexican and Peruvian silver quickly reduced the paper currency to a discount. It was then that Cabarrús presented his project for the establishment of a "national bank". The decree reflected the concern that had existed since the time of Philip II regarding the advisability of creating public banks to facilitate commercial transactions and to combat usury and monopolies, and spelled out the Bank's three exclusive aims. First, to redeem the *vales reales* in specie at par value. Second, to supply food and clothing to the Army and Navy. And third, to meet the Crown's payments abroad. Because of this service, the Bank was granted the exclusive privilege of exporting specie, both gold and silver. From its beginnings it was identified as a national institution and was known as the Banco de España both at home and abroad.²

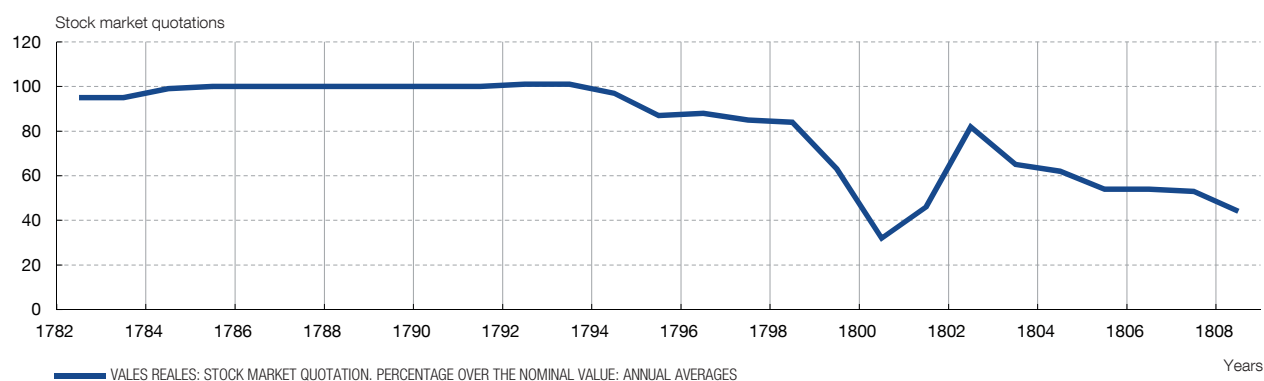
The Bank was established as a private joint-stock company with capital of 300 million reales, a huge amount for the time.³ The Crown, municipalities, religious orders, companies, all social classes in Spain or the colonies and even foreign nationals could be shareholders. The Bank had a governing body of eight directors (with Spanish nationality), although real executive power lay with the general meeting. Unlike the Bank of England, it had no governor or deputy governor. The charter had no time limit whatsoever. Moreover, Banco de San Carlos was granted the possibility (not the monopoly) of issuing banknotes known as *cédulas* bearing no interest and redeemable in cash by the Bank at the will of the holders.

Banco de San Carlos was set up, like other similar European banks, as a private company under the protection of the State and closely linked to the financial needs of the Royal Treasury. Nevertheless, it enjoyed a certain degree of autonomy. The stockholders exercised complete control, at least nominally. The power of the Crown was limited to selecting two of the four stockholders appointed directors of supplies, sending a royal attorney to stockholders' meetings to ensure that the charter was complied with, passing amendments to the charter, and approving actions of the stockholders not envisaged therein.

1 Banco de San Carlos was created 114 years after the Sveriges Riksbank and 88 years after the Bank of England, the two oldest central and issue banks, but 18 years before the Banque de France and 64 years before the Banco de Portugal.

2 For the origin of the Banco de España, see Hamilton (1945 and 1946). For a full history of Banco de San Carlos, see Tedde de Lorca (1988). Also a brief reference in Conant (1896). The standard contemporary reference is Santillán (1865).

3 The real was Spain's unit of account until it was replaced by the peseta in 1868. The peseta was equivalent to four reales. The peseta remained the Spanish currency until the introduction of the euro in 1999. The euro-peseta exchange rate was fixed at 1:166.386.



SOURCE: Herr (1978).

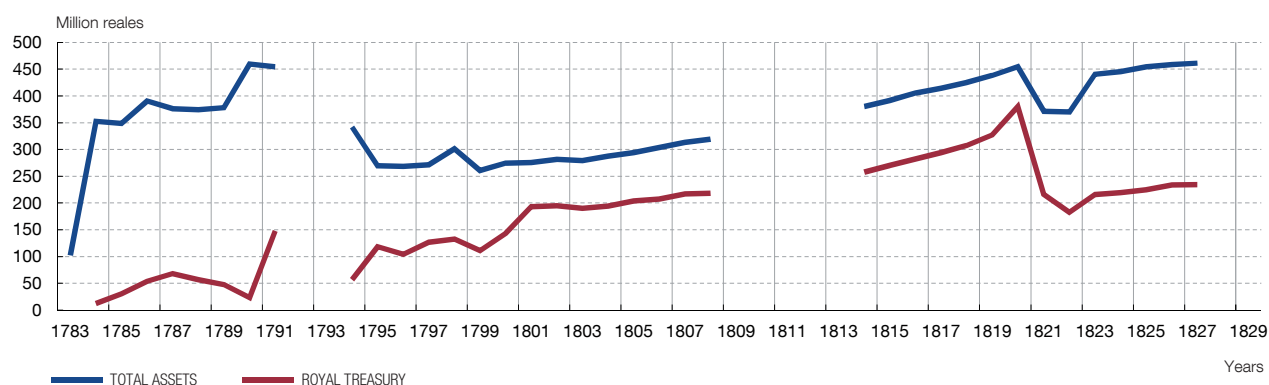
Peace and prosperity, 1782-1793

The first decade in the life of Banco de San Carlos was one of prosperity. Several factors contributed to this, such as peace with England in 1773, the end of inflationary war financing, the vast treasures arriving from the Americas in 1784 and 1785, the withdrawal of one million pesos of paper money from circulation and the timely payment of the annual interest. Despite the increase in the outstanding quantity of *vales reales* following three issues totalling 451.8 million *reales*, their market value held steady, as Figure 2.1 shows. The Bank was able to redeem all the paper presented at par, except during a brief period of a few months.⁴

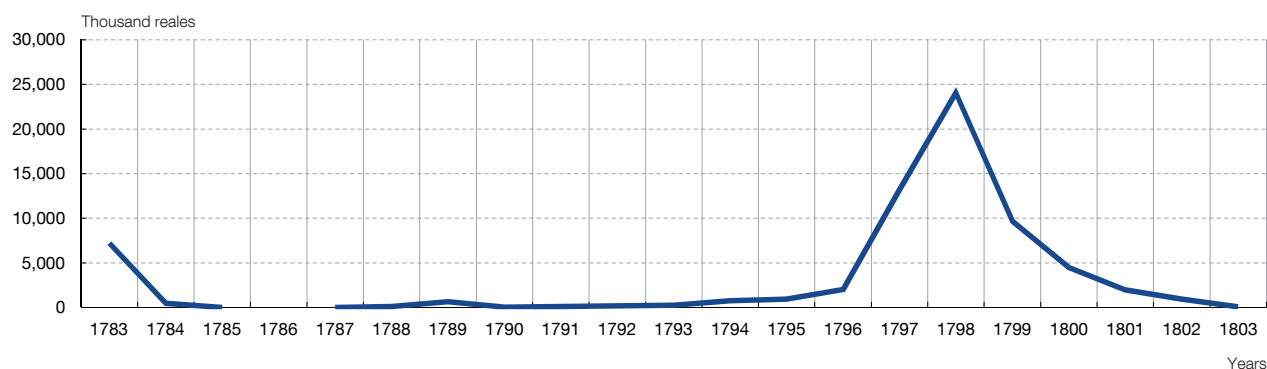
Figure 2.2 shows the exceptional expansion of the decade. The increase in total assets is explained by the medium and long-term credit extended to the Treasury, but also by the expansion of the Bank's ordinary activities as a commercial financial institution, loans and discount to the private sector, investments in infrastructure projects and the purchases of French government debt and shares of the Philippine Company. The funds used to purchase supplies for the Army and Navy also contributed to the positive performance of the balance sheet.

However, despite its rising assets in the early years, the Bank was unable to find sufficient profitable use for its vast amount of capital. The directors tried to find uses for these idle resources, in some cases contravening the original charter. Moreover, the supply of food and clothing to the Army and Navy, besides being an unusual task for a financial institution, presented difficulties from the outset due to the number and dispersion of suppliers, the volume of operations, the uncertainty of the cost and the disagreements with Treasury officials. The Bank admitted that it had been overly optimistic, and later that it had miscalculated the profitability of the business. In 1790, accumulated losses of 38 million *reales* were recognised. To avoid further losses, the Crown offered the Bank the option of terminating its contracts, which the shareholders willingly accepted. The issue of *cédulas* (banknotes) also encountered difficulties and met with unexpected resistance or lack of interest from the public. The failure of the initial issues led the board to withdraw a large part, as Figure 2.3 shows, and can most likely be explained by the fact that they had a high denomination, which was not suitable for small-scale, local transactions and did not offer any remuneration.

⁴ For the *vales reales*, see Herr (1978).



SOURCE: Tedde de Lorca (1988).



SOURCE: Tedde de Lorca (1988).

Quite on the contrary, the export of specie, basically silver, was an excellent business, due to the trade deficit and the payments made on behalf of the Crown to meet its obligations abroad. The monopoly of specie exports accounted for almost half of the Bank's profits.

Apart from the losses derived from the supplies to the Army and Navy, and the lack of enthusiasm for the *cédulas*, the Bank's management faced other adversities. For instance, constant confrontation with the Finance Ministers, due precisely to the question of supplies, because of delays, excessive prices and accounting malpractice with the distribution of dividends out of as yet unrealised profits. The directors were also accused of abusing the privilege of negotiating and discounting their own bills of exchange with the Bank and of extending credit and loans on stocks to the shareholders in contravention of the charter. Another problem were the extreme fluctuations in the price of Bank stock in 1785. These shook its very foundations and were a consequence of a concerted raid by unscrupulous traders in Paris, including Cabarrús himself, who suddenly threw large blocks on the market to break the price, together with heavy sales by alert investors who realised before the general public did that stock prices were unduly high.

War and decay, 1794-1808

During this second period, Spain was involved in uninterrupted wars with the two strongest European powers: first against revolutionary France from 1793 to 1795, and then against England up until almost 1808, with only a brief pause from 1802 to 1804. The military conflicts required the continuous issue of new *vales reales* totalling 1,764 million *reales*, nearly four times the outstanding royal debt. As a result, the market value of the securities fell sharply, as can be seen in Figure 2.1. In 1798 the Bank suspended payment of the *vales* in cash, and the following year their discount reached a low of 30 per cent. At the turn of the century the Bank was unable to fulfil the primary purpose for which it was founded.

The financial demands of war also brought other consequences for Banco de San Carlos, such as its increasing involvement with the government. By the end of 1807, the loans and credits granted to the Treasury amounted to a staggering 217 million *reales*. This indebtedness represented 70 per cent of the Bank's overall balance sheet and 90 per cent of its paid-up capital, which had been reduced from 300 to 240 million *reales* in 1790. The government had absorbed the institution's entire resources. The San Carlos was on the verge of bankruptcy, with largely non-performing assets, since the Treasury was financially exhausted and had neither the funds nor the intention to pay back its debts. Nor could any relief be expected from the colonies, as the British naval blockade had severed trading links between the metropolis and the American territories that were still under Spanish sovereignty. This, in turn, had in practice put an end to the exports of silver, the Bank's only source of income.⁵

Figure 2.2 shows the commercial and financial decay of the Bank. Total assets dropped from their peak of 460 million *reales* in 1790 to little more than 300 million in 1807, a decline of 35 per cent. This also confirms the predominant role played by government debt in the development of the Bank's balance sheet. The institution's relationship with the commercial private sector had ceased and come to almost nothing. The lack of business led the directors to propose a capital reduction, which was approved by the shareholders in 1790. This was also done to absorb losses. However, the amount of *cédulas* in circulation remained unchanged. By the end of 1794 the notes in circulation had risen to 6.4 million *reales*, but by the close of the following year they were down to 4.3 million. Thereafter notes gradually disappeared from circulation, since the public realised how the continuous silver drain on the Bank's reserves endangered their convertibility. In September 1801 the amount in circulation dropped to 2.0 million and a few months later, in March 1802, only 0.9 million remained. The directors then made the decision to remove them from circulation altogether, thus concluding Spain's first experience of paper money.

The Napoleonic invasion, the division of the Bank and its final crisis, 1808-1829

The invasion by the Napoleonic troops in 1808 marked the beginning of the Spanish War of Independence that was to last six years. The institution was split in two, one part remaining in Madrid under the control of the French authorities, the other reorganised in 1810 in the city of Cádiz, where the Spanish Revolutionary Committee established its headquarters. All ordinary activities came to a halt. Both institutions were seized by the respective administrations to ensure that they used their scant resources to finance the corresponding treasuries. The end of the conflict, in 1814, brought the reunification of Banco de San Carlos. An estimation of the volume of funds that had been used to sustain the war effort and a comparison of the Bank's balance sheet in 1808 with that of 1814 revealed that the Royal Treasury's indebtedness with the Bank had increased from 218 million *reales* to 258 million, that is, 70 per cent of its total assets. With outstanding

⁵ Since the 16th century, Spanish Treasury revenues had come to depend on specie imports from the New World. For the situation of the Treasury at the time of Banco de San Carlos, see Artola (1982) and Fontana (1971).

royal debt totalling 12.0 billion *reales*, which accounted for approximately 150 per cent of national income at the time, the likelihood that the government would meet its financial commitments with the Bank was nil. If the institution was paralysed before the war, in 1814 it was near to collapse.

“Nothing could be expected from an insolvent public Treasury long before 1808”, wrote Ramón Santillán, a high-ranking civil servant, historian and future first governor of the Banco de España. The war had left a devastated country, a disorganised administration, an enormous military expenditure bill, worthless property rights and no more funds coming from the colonies which had revolted against the metropolis. “How could anyone expect the Royal Treasury to discharge its debts with the San Carlos?”. And yet, Santillán argued, the only hope for the institution lay with the State itself, with its ability to find the means to rescue the Bank. Because if the future of the Bank was so reliant on the Treasury, the latter’s financial survival also depended on that of the Bank.⁶

The ailing San Carlos, with hardly any activity, lingered for another 15 years. It did not close its doors, but its life as a credit and issuing institution was plagued with difficulties. The almost exclusive concern of the directors was to persistently claim payment of the Treasury’s debt. In 1818 a memorandum prepared by the board of directors detailed the dismal financial situation of the Bank, which was unable to meet even the minimum demand for credit from the private sector. In 1820, when it was on the verge of being dismantled, the Minister for Finance proposed to the shareholders that they exchange their stocks in the Bank for a new issue of Treasury bonds. It was evident that if they accepted, the Bank would go into liquidation. The proposal was rejected and the institution was kept alive, albeit with no purpose other than to recover all or part of the debt owed by the Treasury.

The solution came in 1829 when the government prepared a project to rescue the Bank. Treasury officials eventually recognised that without paying back part of the outstanding credits owed to the institution, the San Carlos would be unable to recover and return to its ordinary financial functions. The Minister for Finance negotiated with the Bank’s directors to provide the institution with fresh money in exchange for writing off the unpaid loans and credits on the balance sheet. The shareholders accepted the plan, whereby the Bank would receive 40 million *reales* in cash in exchange for the 316 million *reales* of non-performing State assets. It meant that the shareholders would have to pay a high price to keep the institution alive, since their financial claims would be reduced by around 90 per cent. The government’s plan also included restructuring the institution, giving it a new name and drafting a new charter. Its starting capital would be precisely the 40 million apportioned by the Treasury. The near collapse of the Bank was a consequence of its close relationship with a poor and penniless Treasury, but curiously enough, the survival of the San Carlos was the result of a rescue operation orchestrated by the Treasury itself.

6 Santillán (1865).

3 The successor: Banco de San Fernando, 1829-1856

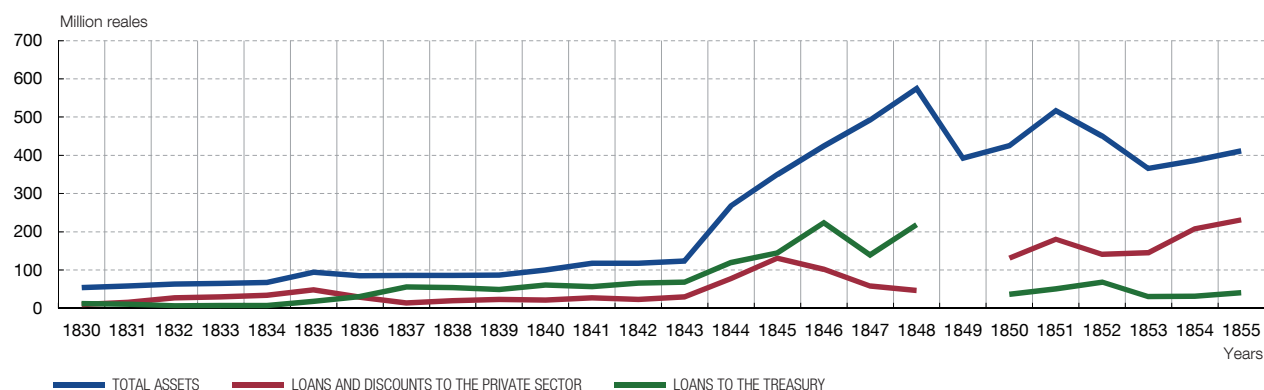
Banco de San Fernando was the immediate successor of Banco de San Carlos. It was established by a Royal Warrant signed by Fernando VII in July 1829, following an agreement reached between the government and the owners of Banco de San Carlos whereby they waived the sum of almost 310 million *reales* owed to them in exchange for 40 million *reales* in stock of the new financial institution. As a result, the San Fernando was formed with paid-up capital equal to the sum apportioned by the State, and with nominal capital of 60 million *reales*. Its duration was set at 30 years, renewable for a similar period. The Bank was authorised to engage in all kind of financial operations, such as discounting bills of exchange and extending loans and credit to the private sector, guaranteed with metallic reserves, government securities and its own stock. Moreover, it could also undertake a broad range of operations with the Royal Treasury, such as making advances to be covered by future taxes, granting loans guaranteed with public debt and, as the financial agent of the government, taking charge of all payment operations abroad. Banco de San Fernando's charter allowed it to open current accounts and receive deposits. It also granted the monopoly on issue of banknotes in Madrid. The charter established that the banknotes should be converted into cash on demand but did not set any issuing limit or specify any reserve ratios. The Bank's management was formed by four bodies: a royal commissioner appointed by the government to represent the public interest and supervise the institution's compliance with its statutes, a director and a deputy director, both appointed by the king, entrusted with executive management, and a board of directors with ten members, one representing the government and the others appointed by the General Meeting. Like its predecessor, the San Fernando was organised by charter as a private joint-stock company under the protection of the Crown.¹

Restraint, followed by war and then expansion

During its early years, the San Fernando's main problem was to find good use for its relatively large capital, while maintaining the financial respectability that its predecessor had lost and the convertibility of its notes at par. In order to achieve both goals, the board of directors restricted lending, limited the issue of banknotes and ensured high liquidity ratios, with cash amounting to double its liabilities at sight and with the majority of its loans and credits to the private sector maturing in 90 days or less. Solvency was also high, as measured by the total asset-to-capital ratio of 61.5 per cent in 1833. Management also tried to keep its financial relationship with the Treasury under close watch, in order to avoid the problems that brought down the San Carlos. Indeed, the memories of the last years of the ill-fated San Carlos conditioned the policies and orientation of the San Fernando for a long time. In short, financial conservatism was the keynote of the first years of the San Fernando.

After the death of Fernando VII in 1833, the period of calm ended, with the outbreak of civil war between the liberal parties, in favour of the succession of the king's daughter Isabel II, and the absolutist factions that wanted to see the brother of the dead king succeed to the throne. The war coincided with the collapse of Spain's empire in the Americas, whose silver wealth had been the financial pillar of the metropolitan State since the 16th century. The government sought alternative sources of revenue: the disentanglement

¹ The history of Banco de San Fernando has been written by Tedde de Lorca (1999). See also, Tortella (1970a) and Santillán (1865).



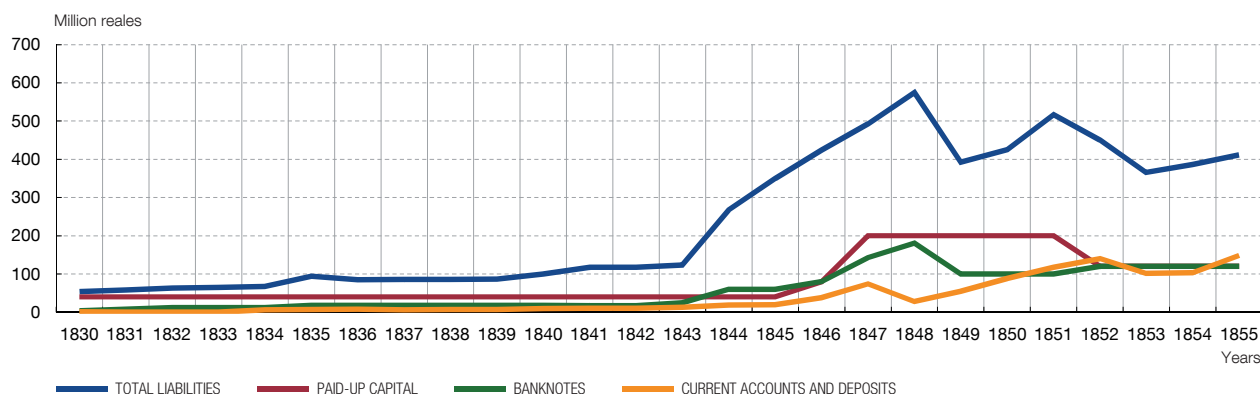
SOURCE: Tedde de Lorca (1999).

(*desamortización*) of Church properties and the negotiation of foreign loans. However, it was not enough and, once again, the Treasury turned to the Bank for help.²

The conflict lasted until 1839, and the San Fernando was called upon, and sometimes forced, to cover the financial needs of the government. As the war went on and intensified, the advances and loans to the government increased in frequency and volume, as Figure 3.1 shows. In 1833 the Treasury's assets accounted for a mere 10 per cent of the Bank's overall balance sheet, but by 1839 this figure had soared to 57 per cent. Less than five years after its foundation, the San Fernando was in a fragile position, heading towards the same financial collapse that had brought down the San Carlos. Further evidence of the repercussions of the war and the demands of the Treasury on the Bank's balance sheet was the increase in the quantity of notes in circulation, from 12 to 18 million *reales* (Figure 3.2). By 1843, when the effects of the war could still be felt, the volume of notes held by the public had reached 24.5 million *reales*, twice the initial figure. Besides, the government asked the Bank to increase its paid-up capital by 20 million *reales*, up to the nominal figure authorised in its charter, in order to strengthen its financial muscle and enable it to provide more financial support to the government. The institution's directors, however, refused. They feared that the war would last longer than expected, and that the government's demands would transform the institution into a mere financial agency of the Treasury. They argued that it would lead to further decline in the already weak market price of its shares, undermining the public's confidence in the institution. They also claimed that a capital increase would adversely affect the Bank's profitability.

The civil war ended in 1839 with the victory of the liberal army. The peace created a new environment for business activity and led to a period of intense, albeit short-lived, economic growth. The disentailment process set in motion in 1836 brought about the rapid expansion of arable land, the cotton textile industry took off in Catalonia, mining production and mining exports grew, the first railway lines were built and a fiscal reform in 1845 modernised the tax structure, increased government revenues and consolidated the floating debt. Renewed investor confidence was reflected in the establishment of new mercantile companies and between 1839 and 1846 the price of public debt bonds on the Madrid Stock Exchange doubled. The economic growth was accompanied and fuelled by a parallel expansion in banking to meet the demand for credit and new means of payment.

² The financial difficulties of the Treasury, in Artola (1986), Comín (1988) and Fontana (1973).



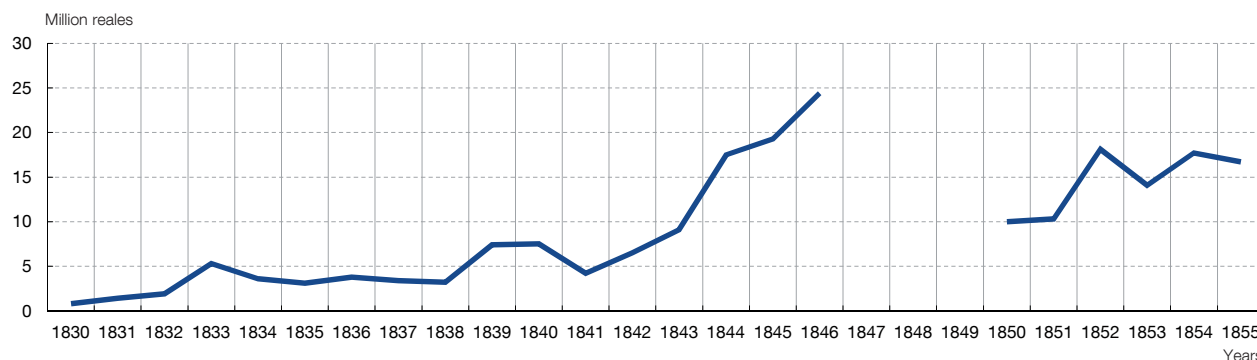
SOURCE: Tedde de Lorca (1999).

In 1844 two commercial and issuing banks were founded: Banco de Isabel II, in Madrid, and Banco de Barcelona, putting an end to the *de facto* monopoly of Banco de San Fernando. Banco de Isabel II was set up with capital that doubled the paid-up capital of the San Fernando and it adopted an active and aggressive lending policy, investing in industrial firms and railway companies. The volume of its notes in circulation and its current accounts soon outstripped those of the San Fernando. Banco de Isabel II also extended its operations to the port city of Cádiz, opening a branch that also had issuing capacity. Banco de Barcelona, on the contrary, started out with paid-up capital of only 5 million *reales*. Its management was more conservative; it granted loans using the merchandise and industrial shares of well-known firms as collateral. Moreover, Banco de Barcelona introduced its banknotes cautiously and maintained relatively high liquidity ratios. In addition to these banks of issue, a number of other commercial and discount banks and savings banks were founded, thereby diversifying Spain's financial structure, increasing the means of payment and extending the structure of the money supply.

For the San Fernando, Banco de Isabel II was both a competitor and a threat. The two banks soon became openly hostile to each other. The former refused to accept its competitor's money, while the latter accumulated large amounts of its rival's notes and presented them for redemption all at once, hoping to provoke the other's bankruptcy. The operation failed, but Banco de Isabel II was able to shake the financial pillars of the San Fernando. To face the challenge posed by its rival, Banco de San Fernando changed its conservative policy. Apart from agreeing to manage debt on behalf of the Treasury, it engaged in new commercial operations. It also willingly continued to provide financial assistance to the Treasury, whose indebtedness with the Bank tripled. As can be observed in Figures 3.1 and 3.2, by 1846 its balance sheet had increased to 424 million *reales*, four times what it was in 1840. Banknotes had also increased, from 18 million to 80 million *reales*, and current accounts from 10 million to 38 million *reales*.

Financial crisis in Europe and Spain: the Bank in the Treasury's grasp

This prosperous period came to an end in 1846. At the end of the year, the economic cycle had definitively turned. The crisis that broke out in London in January 1847 spread to other European financial centres with devastating effect. Panic spread in Madrid as tensions in the money market intensified owing to the acute shortage of cash, the deterioration in the balance of payments and the sharp decline in stocks, with a 30 per cent drop in government bonds. The crisis revealed the weak financial position of Banco de Isabel II. Holders of banknotes and current accounts demanded their conversion into



SOURCE: Tedde de Lorca (1999).

cash and the Bank, short of liquidity, responded by restricting its operations while desperately seeking additional cash. The price of its shares plummeted. The Bank's loans and credits that used its own shares and devalued government bonds as collateral became non-performing. To avoid bankruptcy, the directors of Banco de Isabel II turned to the Ministry of Finance for help. The financial position of Banco de San Fernando, although less critical, was not free of difficulties. The San Fernando's immediate financial future depended on its main debtor, the Treasury, which was also in serious financial trouble and unable to pay off its debts. A solution to avoid the collapse of both institutions was that they be consolidated, and the merger was carried out within a few weeks. However, the operation was rushed and poorly executed. The assets of the two institutions were accepted at their nominal value, without taking into account the quality of the loans, the credit risk or the solvency of the debtors. Shares were exchanged at par, even though the San Fernando's financial position was clearly better.

After the merger, Banco de San Fernando was restructured and its paid-up capital set at 200 million *reales*. However, the Bank's financial troubles did not vanish. In 1848 the economic and political situation throughout Europe took a turn for the worse, and the effects were also felt in Spain. Laden with deteriorated assets inherited from Banco de Isabel II and forced to continue providing financial support to the Treasury, the San Fernando found it extremely difficult to maintain the convertibility of its notes. In May 1848 the quantity of gold and silver in the Bank accounted for a mere 5 per cent of the banknotes in circulation. Panic spread, with holders gathering in front of the gates of the Bank demanding that their notes be converted into cash and riots ensued in central Madrid. The Bank did not suspend payments, but limited its opening hours and restricted the per capita quantity of notes that could be converted daily. Eventually the government had to intervene a second time to rescue the institution. A decree was passed making the San Fernando's banknotes partially legal tender and the Treasury accepted them in payment of taxes and customs duties. The government also arranged a domestic loan to obtain fresh cash to be transferred to the Bank's vaults.³

Two acts were passed in 1849 and 1851 to restructure the Bank and strengthen its financial position. The paid-up capital was reduced to 150 million *reales*, non-performing loans were written-off, banknote issuance was restricted and the distribution of dividends limited. Nonetheless, it took the Bank seven years to recover, and only in 1855 was it ready

³ References to the 1848 financial crisis in Spain in Martín-Aceña (2013), Tortella (1973), Tedde de Lorca (2015), Sardá (1948).

for new undertakings. Seven years during which its activities and operations practically came to a standstill, as shown in Figures 3.1 and 3.2. Its assets decreased from 493 million *reales* in 1849 to 412 million in 1855, while banknotes and current accounts barely increased.

Banco de San Fernando, having enjoyed a period of relative prosperity, fell into the same sort of difficulties as its predecessor 20 years earlier, unable to escape the financial demands of the Treasury. And once again the Bank survived the crisis thanks to the government's intervention. Ultimately, it was the State's financial needs that helped to keep the institution alive. The Treasury needed a financial agent for its own survival. The San Fernando, like the former San Carlos, were privately-owned financial companies, independent of the government according to their statutes, but nevertheless closely linked to the financial affairs of the Treasury.

4 The Banco de España during the period of plurality of issue, 1856-1873

Albeit brief, this period in the life of the Banco de España (the successor of Banco de San Fernando) was marked by a number of significant events in the economic and financial sphere.¹ First, two new laws liberalised the banking sector and initiated a 17-year period of plurality of issue. Second, 1866 saw the outbreak of one of the deepest banking crises suffered by the country, resulting in the collapse of more than half of the institutions created a few years earlier. Third, in 1868, following the establishment of the Latin Monetary Union (LMU), the Spanish national currency, the peseta, was created, unifying the hitherto regional and fragmented monetary system. Despite the challenge entailed by plurality of issue, the Banco de España retained its central position and leadership in the financial system. It continued as a private institution, operating like any other commercial bank and bank of issue, and was able to maintain partial autonomy.

The 1856 law on plurality of issue

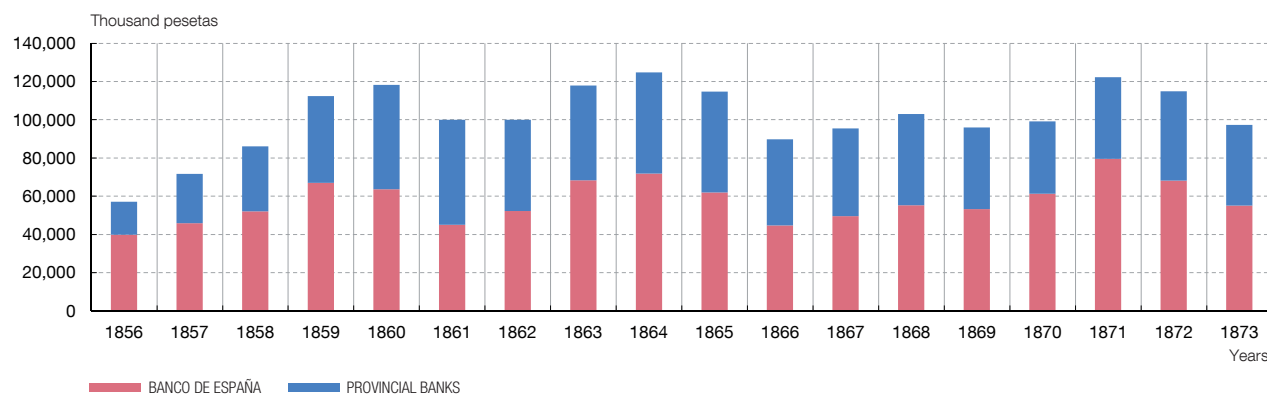
The modern history of Spanish banking began in 1856 with the approval of the Law on Banks of Issue and the Law on Credit Companies. The former established the principle of plurality of issue and renamed Banco de San Fernando as the Banco de España. By 1866 the number of banks of issue had increased from three to 21. The enactment of the Law on Credit Companies led to the emergence of a number of institutions capable of carrying out a variety of activities, ranging from discount and trade credit to long-term loans and investment in industrial stocks and bonds.²

The Law on Banks of Issue was approved as a result of the continuous requests by Banco de San Fernando for elimination of some of the restrictions imposed by the Law of 1851. Its directors argued that there was a need to increase the volume of banknotes in circulation, beyond the 30 million pesetas (120 million *reales*) of paid-up capital, to meet the demand for money of an economy that was growing at a strong pace. In addition, they sought to increase the capital of the Bank and to be allowed to open branches in the provinces. The ultimate aim of the Bank's management was to establish a sole bank of issue that would meet the financial needs of the whole country. The Act also responded to the petition of various provincial businessmen and financiers who were intent on establishing new banks of issue and ending the near-monopoly enjoyed by the Madrid institution. In fact the Ministry of Finance had received a number of applications requesting permission to create banks of issue that would compete with the San Fernando. As the winds of liberalism were blowing strong both in Europe and Spain in the mid-1850s, the government, under the control of the Progressive Party, inclined the balance towards a banking system with plurality of issue.

The Law of 1856 authorised the creation of one bank of issue per town or city, whether a branch of the Banco de España or a new private (non-official) issuing institution. It established a twofold limit on their issuance capacity: notes in an amount equivalent to up to three times their paid-up capital, and a specie (gold and/or silver) reserve equivalent to one-third of the notes in circulation. The capital of all banks had to be fully paid up before they started operations. Government supervision was to be exercised, in the Banco de España by a governor appointed by the Ministry of Finance, and in the other banks through a royal commissioner also appointed by the Ministry. Banks had to be incorporated, their shares had to have a nominal value of 500 pesetas

¹ Martín-Aceña (1987); Martín-Aceña, Martínez-Ruiz and Nogués-Marco (2012); Tedde de Lorca (2006, 2015); Tortella (1970a, 1970b).

² García Ruiz (1991); Sánchez-Albornoz (1963, 1967); Sudrià (1994); Sudrià and Blasco (2016).



SOURCE: Banco de España, *Ensayos sobre la economía española a mediados del siglo XIX*, Appendix.

and be fully paid up. Banks had to be chartered by government decree, they could not extend loans using their shares as collateral, their loans to the Treasury were strictly regulated and they had to publish their balance sheets monthly in the official gazette. The distribution of profit was subject to certain rules, intended to provide for a reserve fund. All banks could undertake all kinds of financial operations. Moreover, the law required the Banco de España to open branches within a year in at least eight cities. The privilege of issue for banks (a *de jure* monopoly in Madrid and in those towns or cities with a branch) was fixed for 25 years.

The Banco de España inherited the capital of Banco de San Fernando: 30 million pesetas that could be raised to 50 million when the needs of commercial transactions so required. Another element of continuity was the board of directors, which remained the same, including the governor who, at the first general meeting, traced the history of the San Fernando, defending its accomplishments over its nearly three decades of existence. Continuity was also assured by the fact that the Banco de España occupied the premises of the San Fernando in the centre of Madrid.

An immediate consequence of the Law of 1856 that liberalised the establishment of banks of issue was an increase in their number, which by 1866 had risen from just three to 21, although after the crisis of 1866 the number had fallen back to 15 by 1873. The Madrid bank of issue was far bigger than the others. Its 50 million pesetas of paid-up capital was more than six times that of Banco de Barcelona, Spain's second largest credit company. Banks such as Banco de Bilbao and Banco Santander, which are today major financial players, were tiny by comparison. Looking at the volume of issue, the same conclusion may be drawn: the Banco de España's banknotes accounted for 64 and 56 per cent of the total in circulation in 1857 and 1873, respectively.

Figure 4.1 shows that the value of the Banco de España's banknotes was greater than that of all the provincial banks combined. Although it had only open two branches, in the cities of Valencia and Alicante, by the 1850s the Banco de España was already a national financial institution, not only in terms of its name but also its size. Its bills were beginning to be used as reserves and it had close links with the Treasury, which included providing tax collection services and acting as the government lender and cashier. These links, which dated back to the institution's origins, had increased over time: in 1857, 59 per cent of its total assets were loans, advances and discounts on letters of exchange and promissory notes to the Treasury; by 1873 the proportion was 70 per cent. Although the Bank defended its independence as a private credit institution, contemporary observers

acknowledged that the government had a great deal of influence over the decisions taken by the institution's board members, since it not only appointed the governor but also used the Bank's funds to meet the Treasury's financial needs. In return, the Bank's directors demanded special treatment and repeatedly asked for the privilege of the monopoly of issue for the whole of mainland Spain and the islands.

Prosperity and leadership, 1856-1863

From 1856 to 1863 the Spanish economy enjoyed a period of prosperity.³ Reforms to modernise the structure of the country and a sustained wave of foreign investment combined to drive up GDP. First a new disentailment law, which this time included not only Church property but especially land owned by secular bodies such as municipalities, lay institutions and the State itself. The quantity of arable land increased, encouraging agrarian production; as a result the country became self-sufficient in cereals. Second, railway construction was promoted by a specific law facilitating the formation of joint-stock companies, providing for subsidies and land grants to those undertaking these projects and unrestricted tariff-free imports of equipment. In less than a decade the basic railway lines were constructed, connecting the main Spanish cities and the centre to the coast. Third, in the industrial area, food processing made significant inroads, mechanical textile production continued to develop and mining expanded. Banking, as mentioned above, was another source of prosperity. And last but not least, large quantities of foreign (British, French, German, Belgian) capital flowed into railway companies and banks, and also into government debt. According to recent estimates, the influx of capital may have been equal to 6 per cent of GDP. All this foreign investment brought to Spain large amounts of gold, which eased the financial hardship of the Treasury and helped to cover the current account deficit.

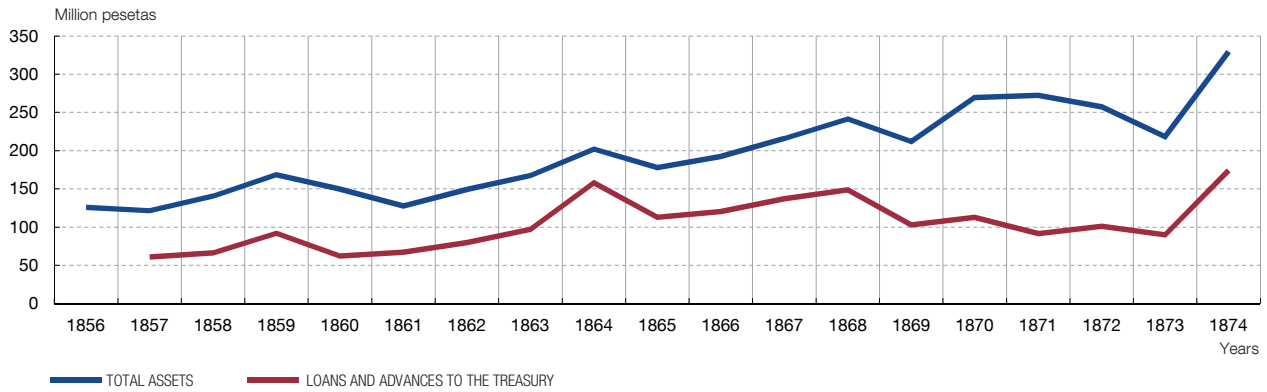
For the Banco de España, also, these were years of prosperity. Despite its initial worries, plurality of issue hindered neither its growth nor the performance of its profit and loss account. Between 1856 and 1863 total assets increased by a non-negligible 30 per cent. Not only commercial bills and loans to the private sector but also loans and advances to government contributed to the expansion. Net profit increased substantially (up to 1861). Dividends per share rose, from 9 per cent in 1856 to 25 per cent in 1861, and then hovered around 16 per cent before the cycle turned. The Bank's stock price on the Madrid Stock Exchange nearly doubled, from 126 to 221. Its notes in circulation almost doubled too, from 40 to 68 million pesetas, and its current accounts increased from 41 to 57 million pesetas (see Figures 4.2, 4.3 and 4.4).

The two laws of 1856 were viewed by shareholders and board members with concern because they challenged the near-monopoly position of the Bank. Even more worrying than the emergence of banks of issue in the provinces was the establishment of powerful credit and investment banks in the capital. The Banco de España feared that the *credits mobiliers* would pursue activities and operations that would adversely affect its business. Furthermore, it was afraid of the threat posed to its banknotes by the credit companies' issues of short-term interest-paying obligations. Another concern was the competition from the Caja General de Depósitos, an official institution formed in 1852 that could receive deposits from the public. Thanks to the latter's increasing financial strength, with deposits paying handsome interest that grew exponentially, the Treasury resorted more and more to the Caja to obtain liquid funds. This left the Bank in a secondary position, to the extent that in 1863 the Bank's advances to the Treasury were a third of the credit the latter obtained from the Caja. To compensate for this loss of business, in 1860 the Bank

3 Tortella (1973).

BANCO DE ESPAÑA: ASSETS, 1856-1874

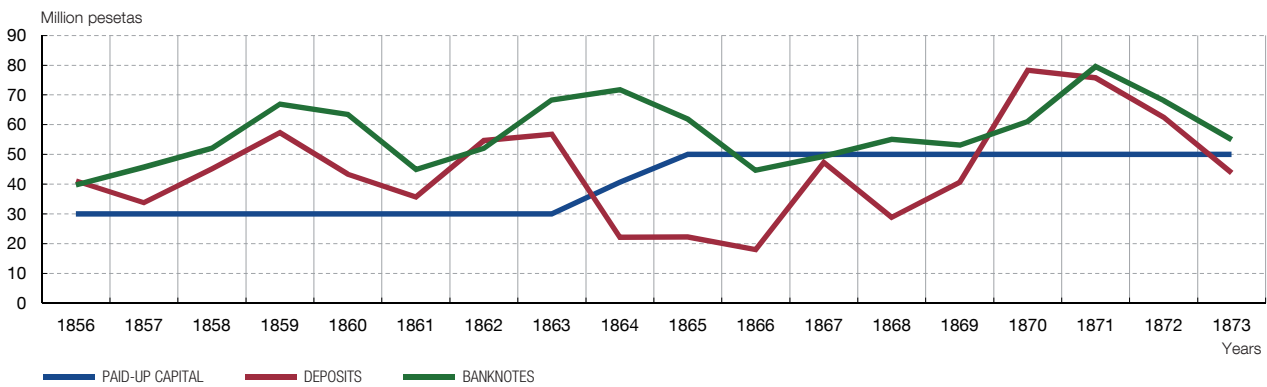
FIGURE 4.2



SOURCES: Banco de España, *Ensayos sobre la economía española a mediados del siglo XIX*, Appendix 1; Tedde de Lorca (2015).

BANCO DE ESPAÑA: LIABILITIES, 1856-1873

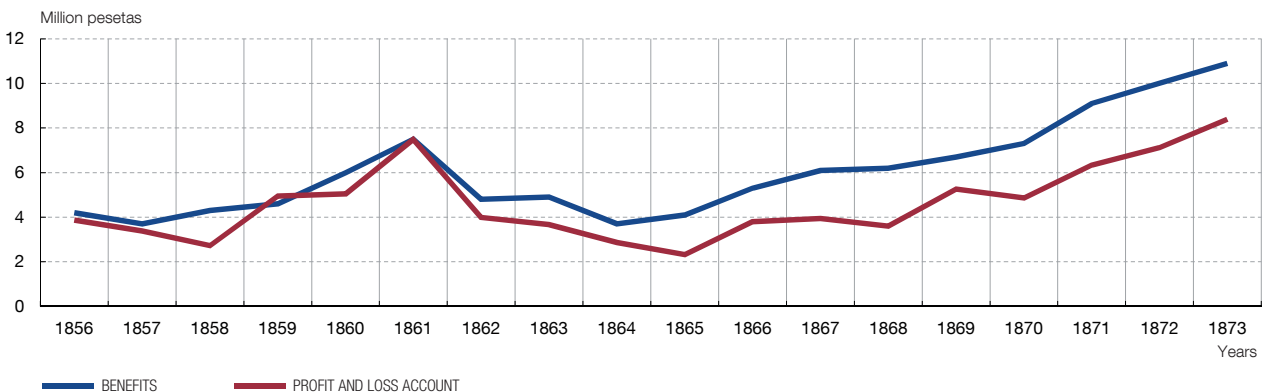
FIGURE 4.3



SOURCES: Banco de España, *Ensayos sobre la economía española a mediados del siglo XIX*, Appendix 1; Tedde de Lorca (2015).

BANCO DE ESPAÑA: PROFIT AND LOSS ACCOUNT, 1856-1873

FIGURE 4.4



SOURCE: Tedde de Lorca (2015).

agreed to assume the entire issuance of special Treasury bills created to finance the extraordinary expenses provoked by the Spanish government's various military interventions in Mexico, Santo Domingo, South-East Asia and Morocco.

In any event, given how the balance sheet and the profit and loss account evolved in the years after the passing of the 1856 Laws, the initial worries created by plurality of issue among the shareholders and board members soon faded. In 1863, seven years after the Laws were enacted, the financial dominance of the Banco de España remained unchallenged. Its paid-up capital of 30 million pesetas was larger than that of all the banks combined. Its banknotes in circulation accounted for 58 per cent of the notes of all the banks of issue combined. And the Bank's current accounts were over three times the sum of the current accounts of all the provincial banks of issue combined.

Times of crisis, 1864-1866⁴

The financial expansion that occurred between 1856 and 1863 came to a halt in 1864. The main protagonist of the economic growth was the construction of the railway system. In less than a decade the main lines were completed and opened to traffic. The promoters of the railway companies were the banks and credit companies founded in the wake of the 1856 banking laws. Banks not only bought stocks and bonds, but also granted loans and advances to the railway companies and distributed stocks in the domestic market and in foreign financial markets, particularly in Paris. However, as was the case elsewhere, the expectations raised by the construction of the railways were overly optimistic. The railways were less profitable than the promoters had promised, and also than the holders of stocks and bonds had expected.

Three additional factors contributed to the crisis. First, the build-up of balance of payments deficits, owing to imports outweighing exports and the rising interest bill on the foreign debt on private and public account that had been contracted in previous years. Second, the increasing scarcity of cash, as both gold and particularly silver were exported to cover the deficit. Third, the debt of the Treasury, whose expenses far exceeded its current revenues. In addition, in the international sphere, there were events that threatened the relative calm of the early 1860s. The end of the American civil war in 1865 caused a sharp fall in cotton prices, leading to business failures and bankruptcies. There was also increasing pessimism in international markets, and among investors and consumers, as a result of the political tensions between Prussia and Austria that would precipitate war in 1866. Throughout the period interest rates increased and capital became dangerously scarce.

Beginning in 1864 the stocks of the main Spanish railway companies plummeted in the Paris Bourse. Mining equity prices and government debt prices also fell. The collapse of the Banco de España's shares in the Madrid Stock Exchange was even more dramatic. With large portfolios of railway shares, bonds and government debt, banks' balance sheets deteriorated sharply and many suffered substantial losses. By the end of the year a major financial crisis was brewing.

The financial crisis erupted in May 1866, the same month in which Overend and Gurney collapsed in London. In Madrid one of the major French credit companies, the Compañía General de Crédito, filed for bankruptcy. The market was shaken and the following weeks saw a chain of bankruptcies. The panic was particularly violent in Barcelona. Two large financial firms filed for bankruptcy – Catalana General de Crédito and Crédito Mobiliario Barcelonés – and a significant number of industrial and commercial firms also went bankrupt. The Barcelona Stock Exchange closed and all banks, except

4 Martín-Aceña (2013); Moro, Nuño and Tedde (2015); Navas and Sudrià (2007); Sánchez-Albornoz (1963, 1967); Sardá (1948); Tedde (2015); Tortella (1970b, 1973).

Banco de Barcelona, temporarily closed their doors. Riots threatened the city and the military authorities declared *curso forzoso* or suspension of convertibility of banknotes in circulation. From Madrid and Barcelona the crisis spread to the rest of the mainland. The loss of confidence in the banking system persisted over the following years.

The 1866 crisis was deep and damaging. Financial and non-financial companies alike went into liquidation. The number of joint-stock banks fell and many private bankers and merchant houses disappeared. Of the 37 financial institutions founded after 1856, only 22 survived the crisis. Of the 82 bankers and private finance houses officially registered in 1866, just 43 were still in operation by 1870. Only savings banks, with no risky assets, remained untouched by the financial turmoil.

Although the crisis wiped out half of the banking system, the financial authorities did not react. No measures were taken and the adjustment was left entirely to market discipline. The *laissez-faire* policy was maintained, and both the Treasury and the Banco de España let the crisis run its course. Most likely the Bank's inaction in 1866 was the result of a deliberate policy to eliminate potential note-issuing competitors.

Instead of introducing legislation to prevent future similar crises, the Ministry of Finance maintained its liberal stance and the authorities took further liberalisation measures. In 1869 a new Joint Stock Company Law lifted all restrictions on the creation of banks of issue, discount banks, agricultural banks and credit companies. Entry into the sector was entirely free and unrestricted with the exception that only one note-issuing bank could be opened in each town or city. Moreover, no regulatory or supervisory measures were adopted. After 1869, therefore, the Spanish financial system displayed similar features to the so-called "free banking system" prevailing in certain European countries and American states.

The Banco de España first started to feel the crisis early in 1864 when depositors and note-holders began to demand that their deposits and notes be converted into cash, fearing that the Bank's excessive involvement with a broken Treasury would lead to the *curso forzoso* of the notes, jeopardising their savings. By September 1864 the Treasury's debt with the Bank had reached a peak of 173.8 million pesetas, and although it declined to 126 million in June 1865 and to 100 million in 1866 the public had doubts about the institution's solvency. The Bank, which had already raised its interest rate to 7 per cent in November 1863, raised it again to 8 per cent in February 1864. It also increased its capital to 50 million pesetas, the maximum limit permitted by the Law of 1856, in an attempt to reinforce its financial position and send a reassuring message to the public. However, the rise in rates did little to attract cash to the vaults, since at the same time the Banque de France and the Bank of England had raised their interest rates to 8 and 9 per cent. In addition, the negotiations initiated by the Bank with various foreign banking houses in London and Paris to obtain credit proved fruitless and the Bank was obliged to increase its interest rate once again to 9 per cent, a level that was maintained throughout 1865.

To make things worse, the Bank's position weakened when the government announced the creation, in April 1866, of a new National Bank, with the participation of foreign investors, with nominal capital of 300 million pesetas, three times that of the Banco de España, and with the monopoly of issue for the whole country. The project was, in part, a response to the previous refusal of the Bank, which was already burdened with a large portfolio of dubious government debt, to advance additional funds to the Treasury. The tension between the Minister for Finance and the Bank's governor led the latter to resign. In return for the privilege of issue, the National Bank was to extend a credit to the Treasury for 400 million pesetas, an amount that was far beyond the financial capacity of the Banco de España. Naturally, the new establishment implied the disappearance of all of the banks of issue, including the Banco de España, which would have had to either

merge with the new institution or become transformed into mere deposit and discount credit companies. Eventually, however, the project failed because the crisis in London led to the collapse, on 10 May 1866, of Overend and Gurney, the main financial firm in the syndicate of London bankers behind the project.

Despite the failure of the National Bank project, the Banco de España's financial difficulties persisted. The run on deposits accelerated and, in July 1866, cash reserves fell to a low of 17 per cent of the banknotes in circulation, well below the statutory requirement of one-third. The 1866 scramble for liquidity – conversion of banknotes into cash – placed the Banco de España on the verge of suspending cash payments. Convertibility was maintained at the cost of restricting the volume that could be exchanged daily and the quantity each note-holder could present for conversion. In addition, opening hours were cut short. The Bank also restricted its lending to customers in order to reduce its notes in circulation. Even so, the demand to convert notes into specie persisted and the notes in circulation among the public reached a discount of 8 per cent. The relief came when the Bank was able to negotiate a 10 million franc credit with Rothschild to buy silver to replenish the cash reserves. This enabled the Bank to reduce its rates, first to 8 per cent, then to 7 per cent and, in December 1866, to 6 per cent.

A slow recovery, 1867-1873

The Banco de España survived the crisis, but not unscathed. Economic and political events delayed a rapid return to normalcy; indeed, prosperity never returned to the previous levels. The revolution of 1868 that overthrew the Bourbon monarchy and the proclamation of the First Spanish Republic in 1873 heightened uncertainty in the financial sphere. Reforms introduced by the revolutionary governments to modernise the structure of the economy and make it more market oriented also fomented an atmosphere of hesitation, because the results would take time to materialise. It was some time before businessmen, consumers and investors, both domestic and foreign, regained confidence.

The Bank did not suspend convertibility at any time, nor did the government declare the *curso forzoso* of its banknotes. Nevertheless, the board adopted harsh administrative measures to restrict their conversion into cash. In 1869 the government commissioned the Bank to collect taxes and customs revenues. This helped the institution regain part of the customer trust it had lost. The Bank was able to accumulate sufficient liquidity to advance, when needed, funds to the Treasury and to maintain a comfortable cash-to-banknotes ratio. Purchases of gold and silver also served the same purpose: having fallen sharply to a low of 19 million pesetas in 1864, cash reserves increased steadily to a high of 102 million in 1871. The subsequent decline was a result of the impact of the 1873 international crisis on the Bank's balance sheet.

As Figure 4.2 shows, total assets fell in 1865 and in 1866 they were still below the pre-crisis peak. They then rose and fell again, so that by 1873 total assets were at a similar level as in 1867. Loans and commercial discounts declined sharply, from 41 million pesetas in 1863 to 11 million in 1866. They increased thereafter, but by the end of the period they had still not regained their previous level. A similar conclusion may be drawn from analysis of the Bank's overall investments in government securities, loans and advances.

The trajectory of the main account headings on the liabilities side of the balance sheet is portrayed in Figure 4.3. The yearly fluctuation of banknotes and current accounts is apparent. It is also clear that by 1873 the value of banknotes in circulation – some 55 million pesetas – was 25 per cent below its peak in 1864. Deposits seem to have increased faster, but in 1873 the recovery still does not appear to be very solid.

Unification of the monetary system; adoption of the peseta as the national monetary unit⁵

In 1868 the peseta became the national monetary unit, as part of a reform of the Spanish monetary system to adjust it to the Latin Monetary Union (LMU) established in 1865. The peseta was a coin originating in Catalonia that had been circulating widely since the early 18th century. It became the new monetary unit because its value at that time was close to that of the French franc. The reform of 1868 mirrored the system adopted by the LMU. The bimetallic gold-to-silver ratio established (1:15.5) was equal to that defined by the Union. Hence the peseta/French franc exchange rate was one-to-one. The peseta, like all the other currencies of the Union, was divided into 100 cents. Peseta coins were to be struck in gold and silver, replacing the diverse and fragmented Spanish metallic coins in circulation. Peseta coins were introduced relatively quickly, in February 1869. The introduction of peseta banknotes took five years. The Bank accepted the reform reluctantly, because it was introduced by a liberal government that had removed the pillars of the traditional political system and replaced the monarch with republican motifs on the banknotes. The first issue is dated July 1874. The Bank's balance sheet and profit and loss accounts were not denominated in pesetas until that year.

5 Although the peseta was not introduced until 1868, this chapter uses the new currency as the unit of account. The peseta was equal to 4 reales. The creation of the peseta, in Comín and Martorell (2003), Fernández Pulgar and Anes (1970), and Sardá (1948). Also references in Tortella and García Ruiz (2013).

5 The Banco de España: a national financial institution, 1874-1913

On 19 March 1874 the Banco de España obtained the monopoly of issue, a privilege it had sought since 1856. The decree radically changed the Spanish financial system, and 1874 is, therefore, a true milestone in Spanish financial history. The end of the plurality of issue saw the disappearance – not without some resistance – of fifteen institutions, which were given the choice between merging with the Banco de España or continuing as credit and discount companies. The majority chose to merge, while four of them decided to maintain their independence. The granting of the monopoly was the result of the dire circumstances of the Treasury. Three simultaneous wars (civil, cantonal and colonial) had led to a considerable rise in military spending, to almost half the budget. Sluggish public revenue growth, owing to the rigid tax system, drove up the budget deficit (to some 3 per cent of GDP) and government debt also increased (to 145 per cent of GDP). Political instability since the 1868 revolution and the proclamation of the First Republic in 1873 made borrowing abroad difficult and expensive, and the interest demanded by private Spanish bankers reached unsustainable levels. Although other measures were taken, such as leasing the mercury mines at Almadén and the Rio Tinto copper mines and authorisation of Banque de Paris et des Pays-Bas to establish a mortgage bank in return for a loan of 100 million pesetas, the Treasury was virtually bankrupt. Salvation was sought from the Banco de España: an urgent loan was requested in exchange for the monopoly of issue.

The justification provided by the Minister for Finance in the preamble to the decree granting the monopoly leaves no room for doubt that it was the Treasury's problems that led to the end of the plurality of issue: "our credit has been lost due to abuse, taxes have been exhausted due to administrative vices, the payment of our debt is at present frozen, and as a result we are forced to use other means to consolidate the floating debt and to withstand the huge costs of the war that has afflicted most of our provinces for two years...". The only possible solution sought was to "create a National Bank, based on the Banco de España ... as a new financial power that can assist the Treasury".

In exchange for granting the monopoly, the Treasury received an advance of 125 million pesetas, at the low interest rate of 3 per cent, which it agreed to return within two years. However, this advance was never repaid and remained on the Bank's balance sheet. The funds were used to avoid bankruptcy and release the Treasury from the financial demands of private bankers. For the Banco de España, the monopoly was similar to being founded anew, and the privilege to issue notes in the entire country transformed it into a genuine national bank and an unequalled financial power. At a stroke it had fourteen branches, enabling it to expand its operations as a credit and discount institution. The Bank was also authorised to double its share capital to 100 million pesetas, which it did a few years later, and to increase it to 150 million pesetas when the economic situation made this advisable (which was the case in 1883). Its issuance capacity also increased significantly, to five times capital (instead of the three times established by the Law of 1851), while the ratio of reserves to notes in circulation fell from 30 per cent (as stipulated by the Law of 1851) to 25 per cent.

The monopoly was granted for 30 years, ending therefore in 1904. However, in 1891, when the banknotes in circulation set by the decree were approaching their maximum limit, the Ministry of Finance reformed the Bank Law and extended the privilege of issue for another 30 years. It also raised the banknote limit to 1.5 billion pesetas, and the metallic reserve ratio to one-third, half of which had to be formed by gold coins or bars. In return, the Treasury received another loan of 150 million pesetas. The issue limit was raised again,

to 2.5 billion, in 1898 owing to the pressing financial needs of the government, required to meet the expenses of the colonial wars in Cuba, Puerto Rico and the Philippines.

The decision of 1874 made the Bank a true financial power, and placed it in a completely dominant position within the Spanish financial system. In 1900 the Banco de España's assets amounted to 2,706 million pesetas, which was 68 per cent of the country's entire credit system. The Bank also became one of the country's most successful trading companies. It became the most important public-private institution, and the only one present throughout Spain, by means of its branches and its banknotes. It was a kind of (financial) State within the State.¹

The making of a national banking system

The monopoly of issue changed the structure of the banking system. In the same way as the adoption of the peseta as the national currency in 1868 unified the monetary system, the centralisation of issue in a single banking institution contributed to the integration of the financial market. This process of integration was based on three pillars: expansion of the branch network, adoption of a unified banknote throughout the country, and establishment of a transfer service between the Bank's current accounts free of charge. A fourth pillar that consolidated the position of the Banco de España as a national institution was its final conversion into the State bank, financing the Treasury and expanding its role as fiscal agent.

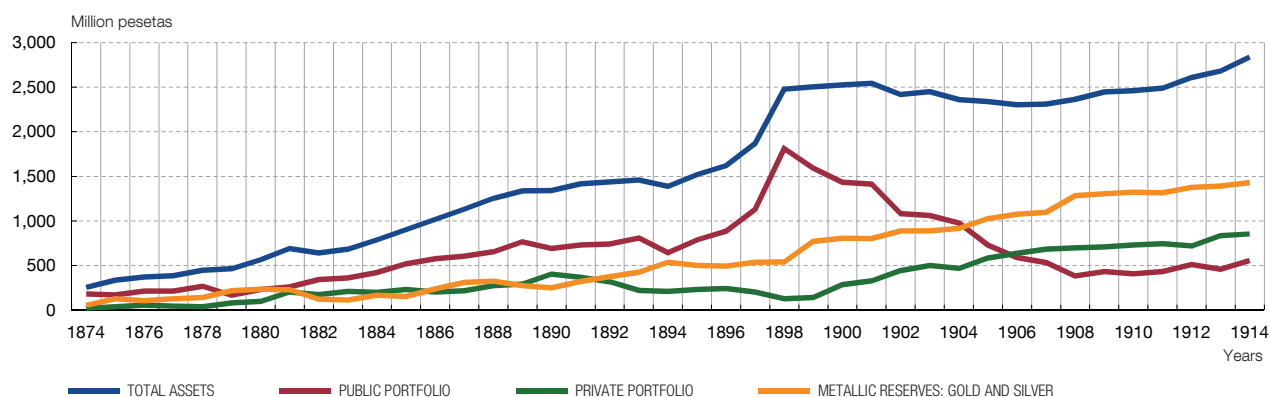
In 1874 the Banco de España had only a central office in Madrid and two branches in the cities of Valencia and Alicante, both opened in 1858. This number was much lower than, for example, the Banque de France, which had 69, and the Bank of England, which had nine. The monopoly decree stipulated that the Bank should establish branches in the nation's main towns and cities to meet the needs of trade. The incorporation of the twelve provincial issuers meant that, by late 1874, there were 14 branches; by 1880 there were 22. Three obstacles prevented more rapid expansion of the network: first, insufficient resources, an issue that was not resolved until 1883 when the government authorised an increase in the Bank's capital from 100 to 150 million pesetas; second, concern about opening and administration costs; and third, the difficulties in finding qualified staff to manage each branch. By 1900 the Bank had opened 58 branches. This number was still much lower than the 392 branches that the Banque de France had opened across the country. Although the financial activities of the branches were limited and their cash reserves were their main asset, they helped transform the former local Madrid-based institution into a truly national institution. More importantly, by 1880 the branch network had unified interest rates. The fact that the central office discounted paper at the same price as the offices in Barcelona, Bilbao and Valencia, to name the most important ones, signified the birth of a national financial market that had not existed a decade earlier.

The decree of 1874 did not bring about the immediate unification of banknotes. This was not achieved until 1884 when the decision was taken to issue the same type of banknote for the whole nation; i.e. a single banknote that was convertible at any branch across the country, as until then, convertibility had been local. Moreover, a year earlier, in 1883, a measure of great significance for the integration of the national financial market was adopted: the Bank began to offer its customers a transfer service between current accounts free of charge and a draft service with a fixed fee. Both measures were immediately successful, as the new system attracted the public's attention and was used by merchants, industrialists and bankers across the country. The volume of transfers increased exponentially, from 500 million pesetas in the first year to 1.6 billion in 1890; by

¹ Anes (1974); Castañeda (2001); Martín-Aceña, Martínez-Ruiz and Nogues-Marco (2013); Tortella (1970a, 2006).

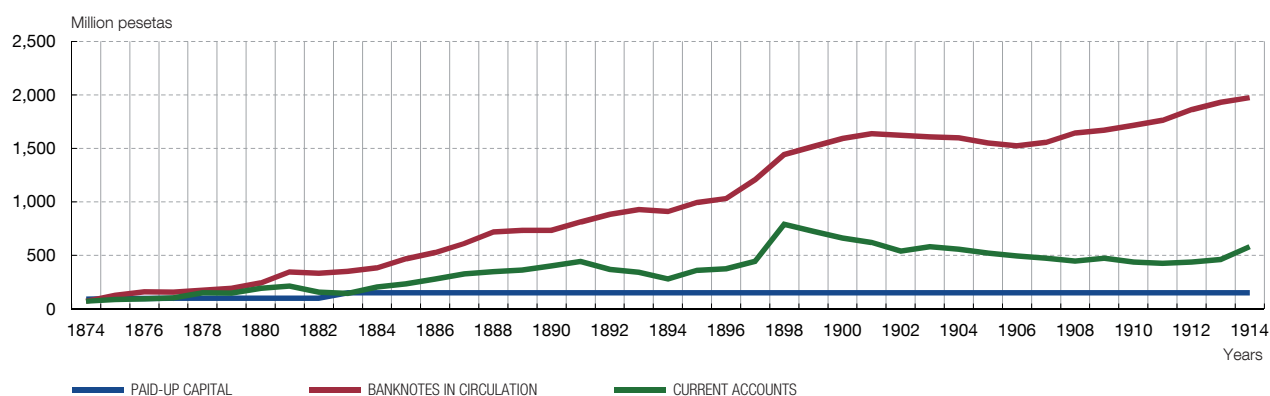
BANCO DE ESPAÑA: ASSETS, 1874-1914

FIGURE 5.1

SOURCE: Banco de España, *Memorias anuales*.

BANCO DE ESPAÑA: LIABILITIES, 1874-1914

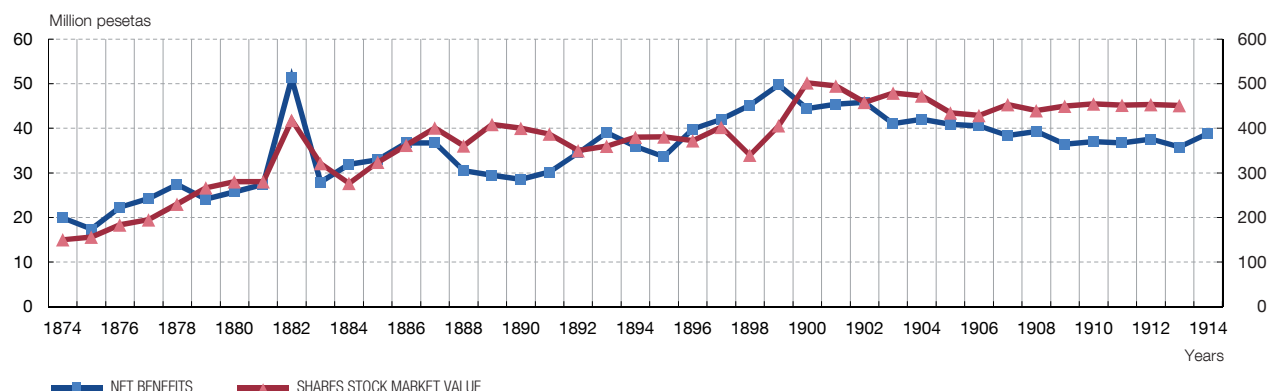
FIGURE 5.2

SOURCE: Banco de España, *Memorias anuales*.

1900 they had multiplied sixfold. Lastly, the Bank consolidated its privileged relationship with the Treasury. The financial agreement of 1868 whereby the Bank assumed the responsibility for collecting taxes in return for making monthly advances to the Treasury remained in place for the following 20 years, and was then renewed for a further five years. Thereafter, the renewal was discussed yearly. The Bank was also responsible for servicing public debt, including making interest payments and repayments of principal

Figures 5.1 and 5.2 provide a cursory overview of the growth of the Bank's balance sheet. Total assets multiplied by a factor of ten between 1874 and the turn of the century. Growth then halted for a few years, for reasons to be explained later, before increasing again to reach a total of nearly 3 billion pesetas. The volume of banknotes also rose rapidly: from 71 million pesetas in 1874 to 1.6 billion by 1900 and more than 1.97 billion before the Great War.

The main factor behind the increase in the Bank's total assets was the public portfolio, government debt purchases and loans and advances to the Treasury which was in permanent need of resources to cover the yearly budget deficits. This is particularly clear in the period after 1895 when a huge amount of funds was required, first to combat the colonial rebellion in Cuba and later, in 1898, to wage the war against the United States on both the Caribbean and Pacific seaboards. When the conflicts ended, the Treasury



SOURCE: Banco de España, *Memorias anuales*.

was able to balance the budget, reduce its recourse to the Bank and thus reduce its debt. By 1914, the public portfolio amounted to barely 20 per cent of total assets, compared with a record level of 73 per cent in 1898. Conversely, loans and credits to the private sector accounted for only a small part of the Bank's overall balance sheet, although they increased after 1900 to compensate for the dramatic fall in the volume of Treasury assets. A further factor that contributed to the expansion of the Bank's assets was the continuous increase in metallic reserves, first the silver component and then, after 1883, the gold reserves, as a consequence of a gold purchase policy designed to maintain public confidence in the banknotes in circulation and ensure their convertibility. Gold in the Bank's vaults increased from a low of 50 million pesetas in 1882 to 720 million in 1914. In fact, by that year, reserves represented half of the Bank's total asset balance, and gold alone a substantial 25 per cent.

Figure 5.2 shows how the three main liability balance sheet account headings evolved. After the increase to 150 million pesetas in 1883, paid-up capital remained unaltered throughout the rest of the period. By contrast, current accounts and deposits rose up to 1898, and then fell back again. Banknotes in circulation showed the largest increases. The maximum limit was set in 1874 at 750 million pesetas, and thereafter changed on three occasions: in 1891 it was raised to 1.5 billion and in 1898 to 2.5 billion; it was then reduced in 1899 to 2.0 billion. Indeed, the increase in the Bank's assets was mostly reflected in the extraordinary increase in the volume of banknotes in circulation, which rose from 71 million pesetas in 1874 to 1,518 million in 1899 and to 1,974 million in 1914. The causes of this thirtyfold increase in banknotes were the Treasury's demand for credit, the growth of the economy and the public's increasing preference for paper money, the decline in silver coins in circulation and the complete disappearance of gold coins, which were the main component of the money supply until 1873. By the end of this period, banknotes held by the public accounted for around half of the total quantity of money.

These were years of prosperity for the Banco de España and its shareholders. There was a marked rise in profits and the rate of return oscillated between a low of 14.3 per cent and a high of 25.0 per cent, well above the profitability of the other commercial banks (see Figure 5.3). The shareholders received splendid dividends throughout, and the stock market value of the shares increased threefold. The monopoly of issue was an excellent business for the Bank, as was its privileged relationship with the Treasury. Providing funds to government to cover its public deficit and purchasing government debt was doing the institution no harm. In this period it was an excellent business and a sure means of obtaining a constant flow of income.

Million pesetas

	1854	1873	1880	1900	1913
Banco de España	128	234	1,067	2,707	2,846
Private banks	48	337	431	984	848
Savings banks and credit companies	n.a.	17	59	131	349
Public credit institutions	—	19	59	63	236
TOTAL	176	607	1,616	3,984	4,279

SOURCE: Martín-Aceña (1987).

The Bank's significance and its central role within the financial system can be gauged from Table 5.1. In the last year of plurality of issue, the Bank's assets accounted for 39 per cent of all financial institutions' assets. A few years later, the Banco de España had become a real financial powerhouse, and this was still the case in 1913 when its assets amounted to more than 65 per cent of the total. The monopoly of issue had transformed it into a "national bank", as the 1874 decree had anticipated. However, transformation into a genuine central bank, that is, an institution assuming responsibility for monetary policy, was still a long way off.

The Banco de España and monetary policy

The last quarter of the 19th century saw the spread of an international monetary system based on gold, linking the economy of the major countries of the world with fixed exchange rates for their domestic currencies. The gold standard offered a common solution to the monetary problems of the period and provided a relatively stable financial framework for economic growth. The appeal of the system can be traced back to the belief that it provided price, income and exchange stability and an automatic mechanism to correct balance of payments imbalances. The gold standard reduced the risks associated with international trade and investment and promoted domestic specialisation and long-term planning, thus contributing to the attainment of higher growth rates. The adherence of almost all of the countries of the international economy was the clearest proof that the system had considerable virtues. Remaining outside the gold standard was unwise, to say the least, unless it could be proven that its adoption would have been catastrophic for the national economy or policy-makers had tried to avoid the purported burden of the system and decided to manage an independent monetary policy in order to promote economic growth. To rule out the gold standard meant implicitly to opt for economic isolation and loose integration with the international economy.

Spain never adopted the gold standard, in striking contrast with the international experience. The convertibility of paper money into gold and silver was maintained until 1883, when it was suspended, and it was never resumed, neither before nor after 1913. Contrary to most European currencies, the peseta thus remained inconvertible into gold and its exchange rate fluctuated in terms of gold throughout.²

Before 1900, the Spanish economic authorities never defined precise monetary goals, except for a vague desire to adopt the gold standard at the official parity established in 1868. The stability of the currency was always a concern, but an explicit policy was

² Llona (2001); Martín-Aceña (1984, 1994); Martín-Aceña, Martínez Ruiz and Nogues-Marco (2011); Ródenas and Bru (2001, 2006); Roldán (2017); Sardá (1948); Serrano Sanz (2004); Serrano Sanz, Gadea and Sabaté (1998); Tortella (2006).

never formulated to assure it. The Ministers for Finance were aware of the fall in the international price of silver, but seem to have been unable to respond. They adopted a *política expectante* (an expectant or wait-and-see policy), waiting to see how other nations responded. They eventually realised that most countries in Europe and elsewhere abandoned bimetallism and adopted a *de facto* or *de jure* gold standard, with or without full gold convertibility or gold circulation. Nonetheless, Spain remained anchored to the bimetallic standard, losing its gold and suffering from a fluctuating exchange rate. After 1900 there were some changes in Treasury policy goals. The adoption of a successful stabilisation programme put an end to the depreciation of the peseta and an array of projects to adopt the gold standard were discussed. But they all failed, because of government instability, a lack of faith in the projects or weak political impetus, and most of all because of the lack of cooperation, and in some cases even the tenacious opposition of the Banco de España.

The members of the board of directors of the Banco de España, as representatives of the shareholders, had two concerns: first, to maintain public confidence in banknotes, and second, to ensure, as any other private financial company, the profitability of the Bank. The first concern entailed keeping in the Bank's vaults the largest possible stock of silver and gold to assure convertibility, in either metal, at the convenience of the Bank. Silver and gold were considered the Bank's property and not an instrument of monetary policy to be used to defend the exchange rate. The second concern, to assure the profitability of the Bank, entailed managing the institution in such a way as to increase yearly profit, so as to assure a permanent flow of returns to shareholders and a high market value for the Bank's shares. The Bank's board did not consider monetary policy its responsibility and the discount rate was managed according to its private interest as a private company. It wished to be neither a lender of last resort nor a banker's bank, arguing that the other credit institutions were simply competitors. For the Bank's board, the issue of banknotes and the Bank's role as the Treasury's financial agent were the only two public responsibilities entrusted to it, both of which it assumed willingly because they were compatible with the overall goal of profit maximisation.³

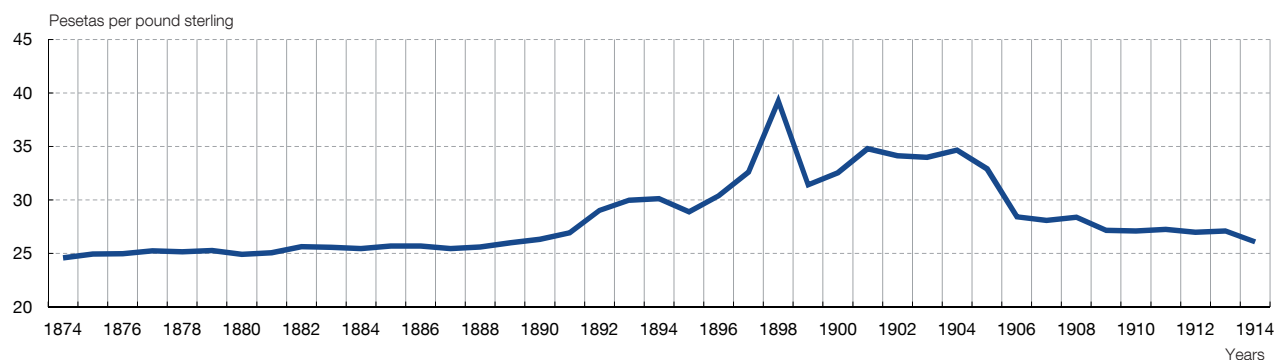
From bimetallism to gold inconvertibility, 1868-1899

In 1868 the Spanish authorities approved a currency reform introducing a bimetallic standard and establishing the peseta as the monetary unit. The official exchange rate between gold and silver was set at the ratio of 1:15.5, similar to that adopted by the countries that in 1865 formed the Latin Monetary Union (LMU). Banknotes were freely convertible into both gold and silver at the official rate.

After 1873 the price of silver on international markets began to fall, and by 1876 the market exchange rate of gold to silver had risen to 1:18. To cope with the *de facto* undervaluation of gold, two options were open to the authorities: to defend bimetallism, with successive devaluations of the official silver price, trying to adjust it to its market value, or to demonetise silver, stop minting new silver coins and adopt the gold standard. Most European countries followed the latter course, including the signatories of the LMU which, in 1878, suspended the free coinage of silver and eventually abandoned the bimetallic standard.

In Spain an attempt was made to follow the example of the LMU. In 1876 the government discontinued the free coinage of silver on private account and gold coinage was resumed (having been suspended in 1873). Furthermore, the Committee on Currency Reform (*Junta Consultiva de la Moneda*) recommended that minting of silver coins be

3 Martín-Aceña, Martínez-Ruiz and Nogues-Marco (2012).



SOURCE: Martín-Aceña (1994).

discontinued and that the gold standard be adopted, but the government ignored the recommendation. However, as the market price of silver fell, the unaltered official ratio undervalued gold relative to the market and, as predicted by Gresham's Law, silver eventually drove gold out of circulation and the Banco de España's gold reserves dwindled. Banknotes continued to be convertible into gold until mid-1883, thanks to successive trade surpluses and a constant influx of capital. Convertibility was suspended in the summer of 1883, following a contraction in foreign investment associated with the Paris stock market crash of January 1882. The measure was taken, so the argument goes, to defend the Banco de España's metallic reserves and halt the disappearance of gold from circulation and the export of gold. But the suspension did not bring the desired results and gold coins did indeed go out of circulation.

After the suspension of convertibility, the authorities allowed the Spanish currency to float freely on the foreign exchange market (Figure 5.4). However, contrary to expectation, there was no immediate decline in its international value. The peseta to pound exchange rate hardly varied and for a few years remained at the rate recorded at the beginning of the decade. Several factors explain this stability. First, a positive balance of trade that may have eased pressure on the market. Second, the public deficit, which remained within reasonable limits, meaning that the Treasury did not need to issue new arrays of short-term bills. Indeed, between 1883 and 1887 there was virtually no increase in either the monetary base or the money supply. In addition, Spanish interest rates were consistently higher than international rates. Lastly, speculators, who had witnessed the quick recovery of the Banco de España's reserves, may have expected a swift resumption of specie payments at par and hence sold gold against pesetas, hoping to make a profit once the exchange rate appreciated.

At the turn of the decade the situation changed: between 1890 and 1895 the value of the peseta fell, moderately but continuously, and the exchange rate to the pound depreciated from 25.6 to 28.9 pesetas. Subsequently, in 1896, the exchange rate began to rise sharply, peaking in 1898 at almost 40 pesetas, which represented a 50 per cent depreciation relative to parity. There can be no doubt that the decision not to adopt the gold standard caused speculators to change their expectations and begin to lose faith in the Spanish currency, reselling their stocks of pesetas. Furthermore, the fact that the government deficit returned and that Spanish and international prices evolved differently also contributed to the rise in foreign rates. The slightly negative growth in the money supply in the same period probably prevented a more pronounced depreciation of the peseta. But after 1896 public spending increased rapidly and the government deficit

widened, especially in 1898 and 1899 when large extraordinary expenditures were approved to finance the colonial wars. To cover the deficit the Treasury was forced to borrow heavily, both from the public and the Bank. Short-term bills were issued for almost 2 billion pesetas; part of this total was taken by the private non-banking sector and part by the financial system, increasing its liquidity considerably, and another part was placed on the central bank's balance sheet. Furthermore, the Treasury requested advances from the Banco de España. The result was a substantial increase in the money supply. The Treasury also secured a significant reduction in the Banco de España's discount rate, from 5 to 3.5 per cent, a measure that was aimed at reducing the cost of the debt. Domestic prices responded quickly, widening the gap relative to foreign prices. Simultaneously interest rates fell and the peseta depreciated rapidly against the pound, to such an extent that, by the turn of the century, the Spanish currency had lost about 30 per cent of its 1880 value.

The end of the Spanish American War, in which Spain lost its last overseas colonies, permitted the return to financial orthodoxy and monetary stability and signalled a marked downward pattern in the exchange rate. At first it fell quickly, followed by a temporary rise and eventually, between 1900 and 1914, a continuous appreciation. In those 14 years the peseta managed to recover almost all of its previous value, reaching a rate of 26.1 pesetas to the pound in 1914, a mere 4.6 per cent below its 1880 value.

After 1900 the authorities introduced a deflationary policy aimed at stabilising the exchange rate. Over the following five years, up to 1905, the stock of money contracted, while the Ministry of Finance carried out a massive conversion of outstanding bonds. Besides, a fiscal reform approved in 1900 provided for successive budget surpluses until 1909. Prices stabilised and within a few years began to converge towards international levels; hence the difference between Spanish domestic and foreign prices narrowed appreciably.

At the same time, the end of the war and the consequent independence of the colonies brought about a substantial repatriation of capital, which peaked in the first years of the new century. The Banco de España also bought up important quantities of gold in order to strengthen foreign reserves. Parallel to this, imports of foreign capital resumed after 1906. Presumably foreign investors viewed the Spanish currency with more confidence, possibly anticipating a speedy re-establishment of the convertibility of the peseta. Accordingly, they reconsidered their investment plans in Spanish assets and, after two decades of retreat, channelled resources into newly developed sectors such as the chemical and electrical industries and public utilities. The exchange rate immediately mirrored the impact of the re-establishment of the old pattern of balance of payments equilibrium: its appreciation was as quick and as spectacular as its previous decline had been. The revaluation and subsequent stabilisation of the exchange rate (and prices) brought about a fall in interest rates, pushing them closer to European levels. All these developments led the authorities to reconsider the adoption of the gold standard, but no final decision was taken.⁴

The adoption of the gold standard: attempts and failures

Between 1902 and 1912 a string of projects aimed at introducing the gold standard, with full redemption of the Banco de España's notes, was discussed. The first move in this direction was made by the Ministry of Finance in January 1902 when a proposal was submitted for the creation of an independent issuance department within the Bank and for gradual repayment of the public debt in circulation, along with a similar reduction in the banknotes held by the public. There were also attempts to make it compulsory for customs duties to

4 Martín-Aceña (2000).

be paid in gold or foreign currency, in an attempt to strengthen the metallic reserves. But these plans were thwarted by the Banco de España, which disliked the idea of increasing the metallic coverage of banknotes and reducing the quantity of notes in circulation.

The second move was also made in 1902, comprising two new laws. The first, promulgated in May 1902, was aimed at reorganising the issuance system, modifying the composition of the Banco de España's assets and limiting fiduciary circulation. For its part the Treasury agreed, over a period of ten years, to return to the Bank the total amount of outstanding debt in its portfolio. In addition, the rules on specie reserves were once again modified, strengthening the gold guarantee of the banknotes in circulation. The second law, passed in November 1902, banned silver purchases by the State once and for all, which also put an end to its silver coinage policy. This was clearly an anti-inflationary policy, since it did away with one of the government's traditional means of creating money. The ultimate objective of all these measures was to reduce the money supply and thus improve the peseta exchange rate. However, full implementation of these measures was hindered by the Banco de España, which always resisted any deflationary policy. In addition, there were significant differences of opinion between the Ministry and the Bank with regard to the application of the laws.

Another law that aimed to stabilise the peseta was presented to Parliament in 1903. It created an exchange office in the Bank, under the supervision of the Ministry of Finance, whose task would be to buy and sell foreign currency on behalf of the Treasury. It was initially endowed with 400 million pesetas, plus funds from a foreign loan that was still to be negotiated. The project collapsed when the government fell.

In the ensuing decade four more projects were discussed, all designed to introduce the gold standard: in 1906, 1908 and two in 1912. The first three sought to completely redeem the floating debt held by the bank, to replace silver with gold as part of the specie guarantee for banknotes and to limit future increases in fiduciary circulation. The fourth proposed the creation of a gold fund to stabilise and defend the value of the peseta by intervening on the foreign exchange market, which would ultimately lead to the introduction of the gold standard. But yet again none of these projects reached fruition.

In summary, the monetary policy pursued between 1902 and 1912 was clearly oriented towards adoption of the gold standard. However, all the projects failed, partly because they never won the support of the Banco de España, and partly because of the fragility of the governments of the time. The failure to adopt the gold standard made Spain a startling exception within the international economy.

These 25 years can be divided into four distinct periods: the Great War; the 1920s; the Great Depression; and the Spanish Civil War. The parliamentary monarchy, which had been re-established in 1874, was overthrown by a non-violent military coup in September 1923 and replaced by a dictatorship. This regime lasted eight years, until April 1931 when a coalition of republican and socialist parties won municipal elections and proclaimed the Second Spanish Republic that would last only five years, up to July 1936. Then followed three years of Civil War. The performance of the economy during this period exhibits different traits. Nominal GDP grew quite steadily from 1914 to 1929, then stagnated during the 1930s and collapsed thereafter as a consequence of the civil strife between 1936 and 1939. Prices rose sharply, as elsewhere in Europe, during the First World War. This inflationary episode was followed by a period of relative stability that ended in 1929 when prices fell, although to a lesser degree than world prices. The years of the civil war were again characterised by inflation.¹

The economic authorities had two main objectives and concerns: balancing the budget and stabilising the peseta. Successive governments and finance ministers failed on both counts. In the financial sphere, two features are worthy of mention. First, the remarkable increase in the number of commercial banks and savings banks and the two banking crises that marked the beginning of each of the decades. Second the comprehensive change in the financial framework that took place following the approval of a banking law affecting private commercial institutions as well as the Banco de España.

The new banking law aimed to transform the Banco de España into a genuine central bank, over and above its responsibilities as a bank of issue and financial agent of the State. The Bank, however, resisted transformation and changed little. Maximising profits remained its major goal. Moreover, it assumed the role of lender of last resort passively and unwillingly, and concern for monetary policy was still far from what the board members considered their duty. The fate of the peseta exchange rate, and whether the currency should or should not adopt the gold standard, was seen as a task for the government, not an obligation for the Bank.

Financial expansion and banking crises. The Banking Law of 1921

Political neutrality placed the Spanish economy in an advantageous position to meet the needs arising from the war: goods and services exports burgeoned, producing a balance of payments surplus and an influx of gold and foreign currency into the accounts of credit institutions, while companies made extraordinary profits and the peseta appreciated. The exceptional conditions generated by the war favoured a rapid process of import substitution, the emergence of new mercantile companies and an increase in the capacities of existing ones. The banking sector was not immune to these developments: between 1914 and 1919 the number of institutions grew from 52 to 91, paid-up capital tripled and deposits quintupled. The number and size of savings banks also increased, founded with the participation of local governments (city and regional governments), the Church, unions and workers' organisations. For the Banco de España, the European war brought an extraordinary increase in both its balance sheet and its gold reserves, as well as rising profits and dividends.

¹ The history of the Bank in this period has been studied by Martín-Aceña (2006), Martínez Méndez (2005), Sardá (1970) and Tortella (1970a). Changes in the banking system by Martín-Aceña (1995, 2012). The impact of the war in Sudrià (1990).

The period of economic prosperity came to a close when the armed conflict ended and was followed, as elsewhere on the continent, by a profound crisis. The establishment of new commercial or savings banks ceased abruptly. Simultaneously, the crisis revealed the weaknesses of many institutions that had been formed in the extraordinary circumstances of the war and were unable to last beyond the armistice of November 1918. Thus, credit institutions began experiencing liquidity and solvency difficulties, followed by some resounding crises.²

The banking crisis was especially intense in Catalonia, although other institutions across Spain also had difficulties. The first problems appeared in the summer of 1920, when Banco de Barcelona, one of the oldest and most prominent Spanish credit institutions, announced major losses. Eventually, the bank suspended payments in November 1920. The crisis caused panic in Barcelona, and all banks suffered a run on funds; Catalan politicians urged officials in Madrid to take stock of the dangerous financial situation. The Minister for Finance summoned the governor of the Banco de España and asked the central institutions to be ready to provide any financial assistance that the Catalan bank might request. However, the Banco de España was not forthcoming and argued that all credit institutions with liquidity problems, including Banco de Barcelona, were insolvent and should not be rescued. That attitude prompted the enactment of the Law of 1921.

Indeed, the fear that bankruptcy would spread, along with the conviction that, due to their special nature, credit companies should be subject to some form of control, was an argument in favour of restructuring the financial system. As in many other continental European nations, the post-war financial crisis brought to the fore the lack of a regulatory framework. The collapse of a major institution such as Banco de Barcelona, and the passive stance of the Banco de España, raised serious concerns in the Treasury as to the adequacy of the legal financial framework.

The new framework took shape in the Banking Law passed by Parliament in 1921. The preamble included a paragraph explaining the necessity of the law: “the banking industry [...] by its nature cannot be an absolutely free industry... banks and credit companies should be subject to some form of control”. Coordination and regulation were needed to avoid excessive competition and individualism, and to defend both the public interest and the stability of the financial structure. Banks’ failures not only affected shareholders and depositors but could also spill over to the rest of the economy with devastating effects. Lack of restraint and imprudent behaviour, such as excessive risk-taking by individual banks, could endanger the functioning of the whole financial structure and undermine the soundness of the banking system. Hence, a prudential regulation policy was needed to ensure the proper functioning and stability of the banking system.

An important provision of the 1921 Law was the establishment of the *Consejo Superior Bancario* (CSB), a body entrusted with broad regulatory and supervisory powers. It could set minimum capital requirements and pricing limits and also maximum rates for current accounts and deposits. It could also establish the proportionality between different items of banks’ balance sheets, such as the ratio between total earning assets and short-term liabilities and the ratio of total deposits to paid-up capital plus reserves. The law compelled banks to submit monthly balance sheet statements to the CSB and to publish their income statements. Moreover, the CSB was the agency in charge of compiling all banking statistics. It was responsible for designing the balance sheet and income statement models to be submitted by all financial institutions. It was also empowered to investigate bank operations and accounts and to impose disciplinary sanctions. As a consultative body it could advise the government on financial matters.

2 Martín-Aceña (2013) and Martín-Aceña, Pons and Betrán (2014).

The second goal of the 1921 Banking Law was to transform the Banco de España into a true central bank and to increase State control over the institution. The authorities believed that the post-war crisis could have been avoided had the Bank behaved as a real lender of last resort. The legislator's objective was to increase the State's intervention in the Bank, while extending its issuing privilege for another 25 years, up to 1946. The Law also authorised the Bank to increase its capital from 150 to 177 million pesetas and to raise the limit of banknotes in circulation from 5,000 to 6,000 million pesetas. In addition, it provided for the Treasury to have a share in the institution's profits. The discount rate was left in the hands of the Bank's board, while the interest rate on loans and credits guaranteed by sovereign bonds and debt had to be determined jointly by the Bank and the Treasury. The Law limited the amount of advances that the Treasury could obtain from the Bank and determined the quantity of banknotes in circulation; any change over and above the established limit required government authorisation. In order to strengthen the links between the banking community and the Banco de España, the Law forced the latter to give preferential treatment to credit institutions; in particular, it established that financial institutions could discount paper at a preferential rate. The Law did not prevent the Banco de España from operating with the non-banking private sector, but it set a ceiling on the outstanding amount of private securities in its portfolio. Moreover, the Law aimed to make the institution the executor of the government's monetary and foreign exchange policies. To that effect, it included a clause whereby the Bank was obliged to cooperate with the Treasury in the event of intervention in the exchange rate market and in the eventual introduction of the gold standard.

The Bank as lender of last resort

The enactment of the 1921 Banking Law and the establishment of the CSB did not prevent a new wave of banking failures. As discussed above, the financial institutions entered the 1920s burdened with many unresolved problems. A certain number of banks were unable to write off bad loans and dispose of devalued stocks. For a limited period, banks could carry large losses by running down reserves built up during previous years. But as the recession deepened and share prices did not rise, industrial recovery was delayed and the financial situation deteriorated. Eventually, the difficulties re-emerged after the summer of 1924. The new crisis appeared as a continuous run on bank deposits, which lasted nearly a year, until September 1925. All in all, between 1924 and 1926, half a dozen salient banks failed and were forced to liquidate their assets, including Banco Central, one of the biggest and most influential institutions, whose problems threatened to shatter the whole financial structure.

Initially, the Banco de España's position was to ignore the situation and later, when it was subjected to certain pressures, to argue that the banks' problems were not its concern. Its directors alleged that the Bank was not the guardian of poorly managed institutions; if these had made unwise loans, it was logical for them to fail and their directors were at fault. However, when the crisis affected Banco Central, one of the country's largest institutions, whose demise would have amplified the crisis with grave consequences for the national economy, the Banco de España had to intervene to prevent its bankruptcy. In fact, it did so at the behest of the head of the Military Directorate, Primo de Rivera, who gave a direct order to the governor to assist Banco Central and stave off its fall.

The second half of the 1920s was relatively quiet for the banking system, with no major bankruptcies or panic episodes. Deposits grew at a moderate pace, universal banking became firmly established, big banks opened branches throughout the country, foreign banks expanded and opened new branches, and the government promoted the establishment of official or semi-public banks designed to meet the credit demand of special sectors.

The calm of the late 1920s came to end in 1929. Although the Great Depression was less severe in Spain than elsewhere in Europe, the spring of 1931 was politically complicated and financially unstable. The demise of the monarchy, the proclamation of the Second Republic and the formation of a coalition government with various socialist ministers brought anxiety and fear to the business community and to the public at large. News of the failure of the Creditanstalt and the difficulties of central European institutions also contributed to the climate of gloom. The crisis erupted in April 1931. The run on banks was intense between April and June and withdrawals of funds continued during the summer and up to the end of September. By that time, when the crisis was effectively over, the total volume of deposits had declined by 20 per cent from the total in March 1931. Banks did not fail because they were able to obtain all the cash they needed to convert deposits into currency.

Two reasons may help to understand what made this possible. For the first time, the Banco de España was ready to behave as a lender of last resort and, second, banks had plenty of liquid assets. When the run started, the government made a swift and surprising move to deter the crisis. The Ministry of Finance summoned the governor and the deputy governor of the central bank and all members of the CSB and urged them to reach a compromise. All agreed that banks were basically solvent but could run into serious difficulties owing to a lack of liquidity. In consequence, the Banco de España, for the first time in its long history, and the Treasury, agreed on combined measures to provide all the cash banks might need. The government authorised an increase in the limit of banknotes in circulation, and the Bank's directors agreed, also for the first time, to lend freely; this meant that they would discount bills on demand and would unhesitatingly accept eligible paper as loan collateral. Since the crisis coincided with a flight from the peseta, the government also authorised a rise in interest rates to halt the outflow of capital. The other reason that contributed to preventing banks from collapsing was the fact that Spanish banks had a plentiful supply of gilt-edged securities; they simply pledged their unused portion of government paper on their balance sheets to obtain cash. Thus, banks' holdings of public securities, used as collateral, acted as an automatic built-in stabiliser. So the rapid and unexpected intervention by the Bank, plus the ability of banks to monetise their holdings of government paper, explains why financial institutions did not collapse in 1931.

The Banco de España and monetary policy³

The Spanish authorities were well aware of the worldwide re-establishment of the gold standard after the war. They, too, aimed at a prompt stabilisation of the peseta. The opportunity came after the return to the gold standard in Britain, France and Italy. At the same time, a short-lived episode of peseta appreciation raised officials' expectations that the currency would soon reach the parity of 1868 (25 pesetas to the pound). Plans to join the gold standard began in 1927, and lasted until 1932. The attempt, however, failed. Stabilisation required two complementary measures. First, a decisive policy by the Treasury to impose financial discipline to balance the budget. Second, the Banco de España's cooperation, a willingness to raise interest rates when needed and to defend the exchange rate with its metallic reserves where necessary. However, neither of these two requirements was met. Despite statements to the contrary, the Treasury was never willing to enforce the necessary financial discipline, either before or after 1929, although it did manage to reduce the budget deficit. But most especially, the Banco de España was not prepared to employ its huge gold reserves to sustain the exchange rate, when a

³ Martín-Aceña (1984).

continuous and unstoppable depreciation began in 1928, intensifying in 1929, when the pound sterling exchange rate rose to 33 pesetas. The depreciation became even more marked in 1930, and up to early September 1931, when the price of the pound reached a historical high of almost 60 pesetas.

The Bank's board maintained, as it had done systematically, that exchange rate stability was not among its responsibilities and that the gold deposited in its vaults belonged to the shareholders, not to the Treasury, and was there to back the value and prestige of the banknotes in circulation. Since the Banco de España stubbornly upheld this view no matter who led the Ministry of Finance and no matter what political regime was in place, whether the dictatorship or the Second Republic, the government eventually decided to amend the Banking Law of 1921. The reform was a response to the non-collaborative stance of the Banco de España in the government's attempt to defend the peseta exchange rate. The Bank vehemently refused to side with the Treasury and commit its huge gold reserves to contain the depreciation of the currency. No matter how inappropriate and untimely, in the spring of 1931, was the intention to stabilise the peseta and adopt the gold standard, the Minister for Finance believed that the Bank ought to have supported official policy. But the owners and directors of the Bank considered that defending the exchange rate was not among its responsibilities.

The 1931 reform did not affect the banking system and there were no changes in the supervisory framework. The amendments to the Law referred exclusively to the role and responsibilities of the Banco de España. In essence, the aim of the reform was to increase the government's control over the Bank. The composition of the Board was changed to include three members appointed by the Ministry of Finance, to represent the "national interest". The other significant change was the obligation imposed on the Bank to place its gold reserves at the disposal of the Ministry in the event of official intervention in the foreign exchange market.

The Banco de España's balance sheet

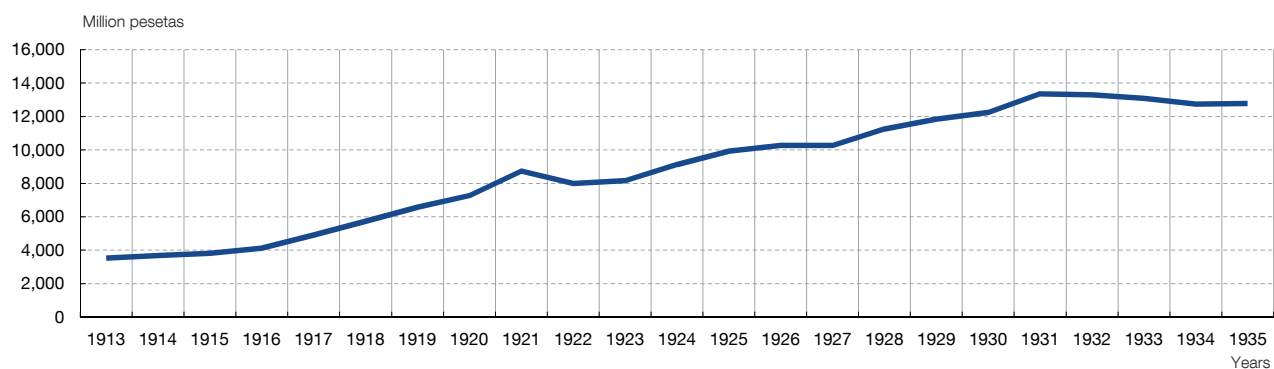
The Bank's balance sheet was a reflection of the prevailing financial events. Figures 6.1, 6.2 and 6.3 portray the changes in the institution's overall balance sheet and main assets and liabilities. In 1913 total assets amounted to 3,531 million pesetas; by 1931 they had reached a high of 13,353 million. Thereafter, the figure fell slightly, to 12,782 million in 1935, the year before the outbreak of the civil war.

This extraordinary increase was due to the combined action of two forces. During the First World War, gold reserves increased from 675 million to 2.5 billion pesetas. This accumulation of gold was the result of successive balance of payments surpluses and of a deliberate policy of gold purchases by the Bank to strengthen its metallic holdings. Board members believed that "gold" was the key to building public confidence in the institution's solvency and in the value of the banknotes. The second force behind the expansion of the Bank's balance sheet were the loans and credit secured by government debt that was issued in large quantities both during the war years and the 1920s. The debt was issued, as in the previous period, to finance the ordinary budget deficits and, in the second half of the 1920s, to cover the expense of an extraordinary budget destined to finance a huge public infrastructure programme. The debt found its way onto the balance sheets of private banks and savings banks, which later monetised it by pledging the securities to the Bank. Thus, the banks profited from the differential between the interest rate of the debt and the (lower) interest rate applied by the Bank.

Other factors played a minor role. Loans and credit to the non-banking private sector hardly exerted any influence on the overall changes in the Bank's balance sheet. This is partly a consequence of the 1921 Banking Law, which obliged the Bank to reduce its commercial operations with the non-banking sector and strengthen its financial relationship

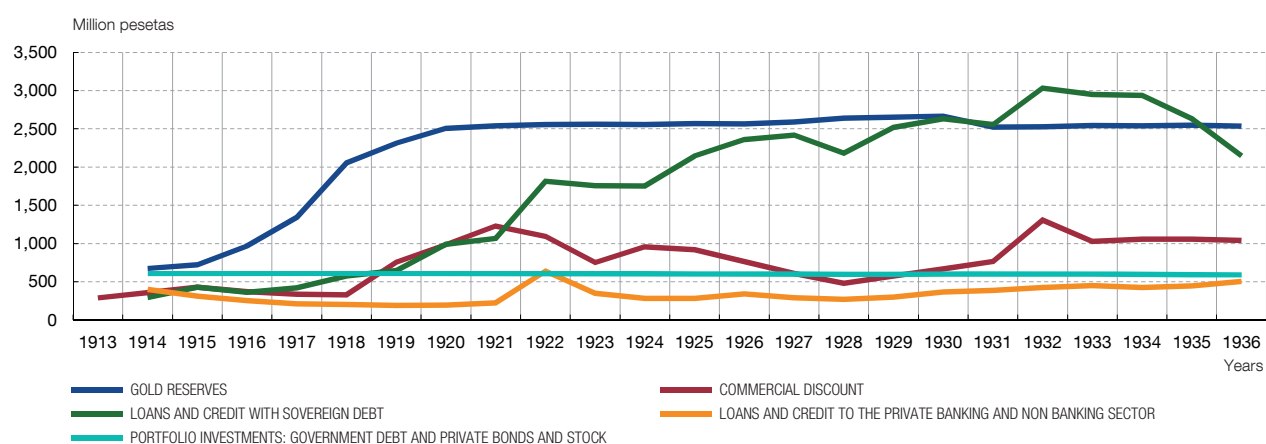
BANCO DE ESPAÑA: TOTAL ASSETS AND LIABILITIES, 1913-1935

FIGURE 6.1

SOURCE: Banco de España, *Memorias anuales*.

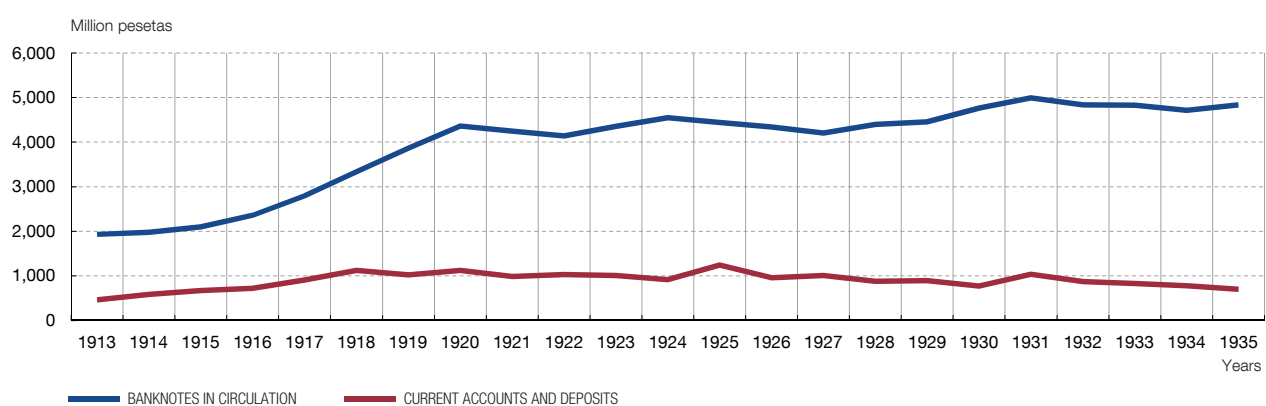
BANCO DE ESPAÑA: ASSETS, 1914-1935

FIGURE 6.2

SOURCE: Banco de España, *Memorias anuales*.

BANCO DE ESPAÑA: LIABILITIES, 1914-1935

FIGURE 6.3

SOURCE: Banco de España, *Memorias anuales*.

with other credit institutions, commercial banks and savings banks. The volume of the Bank's investment portfolio was also the result of applying the 1921 Law, since it limited the type and quantity of shares and bonds of private companies that the Bank could hold.

The quantity of banknotes in circulation mostly shows a clear upward trend throughout the Great War. Thereafter, during the early 1920s, the rise was minimal. Banknotes increased again after 1927, until 1930, and then fell during the 1930s. The changes introduced by the Banking Law prompted little growth in current accounts and deposits. The other cause of their stagnation was, undoubtedly, the higher competition faced by the Bank from private credit institutions, which grew in number, extended their geographical influence and enlarged and expanded their financial capacity.

The Banco de España and the financing of the Spanish Civil War, 1936-1939

The military uprising that began in July 1936 split the country into two opposing factions, leading to two antagonistic states. This geographical division led to a breakdown of the financial system. The Banco de España was also divided, with the official institution remaining under the control of the Republican government, while a parallel administration was created in the territory controlled by the nationalist faction. The monetary unit, the peseta, also collapsed, and for three years two different and opposing currencies were in circulation: the Republican peseta and the nationalist one.⁴

The division of Spain's monetary community took place immediately after the outbreak of the war, in three stages: first, the splitting of the Banco de España into two independent institutions; second, the reciprocal annulment of legal tender issued by each of the warring factions; and third, the freezing of bank money. As mentioned, the Banco de España was effectively divided into two institutions, each with its respective and independent boards of directors. The one in Madrid remained under the control of the Republican government and continued to function there until it was moved to Valencia in November 1936 and then to Barcelona at the beginning of September 1937. An alternative nationalist institution (the "Banco de España nacional") was set up in Burgos. The second step leading to the breakdown of monetary unity in the country was in November 1936 when the National government's Technical Committee decided not to recognise the validity of any banknotes issued by the Republican Banco de España (in Madrid) and put into circulation after 18 July 1936; the Board in Burgos also agreed to issue its own banknotes. Later, in August 1938, the country's monetary division grew deeper when it was decided to explicitly prohibit the possession of the enemy's currency, which was considered to include not only the banknotes issued since the date of the uprising, but also the silver certificates issued by the Republican government and the paper money issued by the Treasury in Madrid. The Republican government responded in January 1937, prohibiting the possession and circulation of nationalist banknotes, which were stripped of their value and dissociated from metallic reserves. This brought about a radical separation of what was considered legal tender in each zone. Two issuing institutions and two different pesetas had sprung up and they were to follow very different paths, in terms both of their exchange rate abroad and their domestic value. Just as important as the relative stipulations concerning legal tender, was the policy of freezing bank deposits adopted by the Burgos government in the areas occupied by the army. According to a series of "Instructions" to commercial banks and savings banks that entered into force in July 1937, only the account balances existing on 18 July 1936 were recognised as fully valid, and any movements or operations that had taken place after that date were subsequently reviewed.

⁴ Martín-Aceña (2006).

The civil conflict also disrupted Spanish mercantile activity. The Republican government suspended stock market activity and commercial operations that implied movements of funds in credit institutions. In both zones measures were taken to postpone interest payments and redemption of public debt. At almost the same time, a moratorium was established on commercial bills and mortgages on real estate in order to avoid an accumulation of default that would have led the system to overall insolvency. All of these stipulations blocked a multitude of mercantile activities because, although they were adopted provisionally, they seriously affected the way companies and individuals worked. In the Republican territories, the moratoria, suspensions and rules regulating commercial and banking operations that had been imposed in the early months of the war remained unchanged until the war ended. Likewise, the exceptional legislation passed to regulate all aspects of the internal administration of corporations affected how they worked and paralysed many of their decisions, so that many investment projects were abandoned.

The war was financed by both sides using internal and external funding.⁵ Internal financing on both sides was obtained mainly through issuing money. The total expenditure of the Republican government during the war amounted to 40 billion pesetas. The Republic raised more than 24 billion pesetas through advances and credit from the Banco de España. Hence, the issue of new money represented 60 per cent of the Republicans' total revenue. The deficit of the Nationalists during the war amounted to 8.26 billion pesetas. Of that figure, 7.2 billion was covered by loans and advances from the Nationalist Banco de España and the remainder (1.06 billion) by debit balances in different accounts of the Bank. All in all, new money accounted for almost 70 per cent of the recognised internal expenses of the Nationalist's civil and military administration during the war.

Foreign funding to pay for the war was especially relevant because Spain did not have the capacity to produce military goods, so imports were essential to maintain the war effort. Franco was able to purchase his military equipment with German and Italian "aid" and with loans from private banks in Portugal, Switzerland and the United Kingdom. The most important source of funding, owing to its scale and its strategic significance, was the "aid" received from the Axis powers and which included troops, military experts and military supplies on credit. The terms on which this financial assistance was provided varied over time and by country, but the arrangements, timing and control of the funds were always in the hands of the nations providing the aid. Nonetheless, in all cases it was agreed that the advances and credits were to be settled at the end of the conflict.

The total aid received from Mussolini's Italy has been calculated at between 7,000 and 8,668 million lire (377 to 467 million dollars). German assistance to Franco included supplies to three armies channelled directly through the administration and indirectly through private agents, the cost of the personal expenses of the German air forces, the Condor Legion, obligations with HISMA (the German company responsible for bilateral trade) and, lastly, various credits granted by the Department of Economy and by private agents. All in all, the total amount of Nazi aid is estimated at 253 million dollars. Taking into consideration the loans from all sources, Franco's civil and military administration borrowed as much as 729 million dollars.

Unlike the Franco regime, the Republic received no significant foreign financial assistance, except for a Soviet credit in 1938 (for around 70 million dollars). The Republican government did not float debt in London, Paris or New York, despite having a large amount of gold to use as collateral. Although the Republican government did not resort to external borrowing, it was not short of international means of payment, as it controlled most of the gold and silver reserves of the Banco de España. At the outbreak of the civil war, the

5 Sánchez Asiain (2012); Martín-Aceña, Martínez-Ruiz and Pons (2012).

metallic reserves in the Banco de España that could be mobilised to finance the war amounted to some 635 tons of fine gold, equivalent to 715 million dollars. These reserves were ranked fourth in the world, behind the reserves held by the Federal Reserve System, the Banque de France and the Bank of England (excluding those held by Gosbank, the Soviet central bank). This huge amount of gold had been accumulated during the First World War, thanks to the special conditions created as a result of Spain remaining neutral. By the end of the Civil War, the Republican government had exhausted these reserves in the purchase of military equipment, ammunition, food and raw materials abroad.

The gold reserves were sold in two stages. First, the Banque de France acquired 175 tons of fine gold, for which the Republican government obtained 3,922 million francs (around 196 million dollars). In the second stage, all the remaining gold (460 tons of fine gold valued at 519 million dollars) was sent to the USSR and deposited in Moscow in the vaults of the Gosbank. In addition to the direct sales, a few months before the end of the war the Republican government obtained a 70 million dollar credit guarantee from the Soviets with the remaining gold deposit made in 1936 (34 tons). This meant that when the conflict was over, the entire gold reserves of the Banco de España had been exhausted. Moreover, when most of the gold had gone, the Bank's silver holdings (1,225 tons) were put up for sale. In this case, the main buyers were the United States Treasury and the Banque de France. In exchange, the Republican government received around 15 million dollars. There were also some silver sales to private French and Belgian firms that yielded an additional five million dollars.

Both sides spent roughly the same amount of foreign funds, although the lenders and the origin of the funds were different: the Republican government obtained 769 million dollars from its dealings with the Banque de France and the Soviets, while Franco received 729 million dollars from his political allies, Germany and Italy.

The growth of liquid means of payment created by both the Republican faction and the Nationalist government has been estimated. All in all, banknotes and current accounts increased from 6,525 million pesetas in July 1936 to 40,601 million in March 1939 when the war ended. Total assets also reflected the role played by the two central banks financing the military needs of both sides. In December 1935 the overall balance sheet amounted to 12,782 million pesetas; by 1941, before the financial settlement of the war, it stood at 46,670 million. Nevertheless, after the necessary accounting adjustments, that is, elimination of the gold reserves consumed and write-down of non-performing loans and credits, including all those made to the by then non-existent Republican government, the overall balance sheet stood at 23,085 million pesetas, twice that of 1935.

The start of this period was marked by the financial settlement of the civil war, and the end by the law nationalising the Banco de España. For most of these years the Bank played a secondary role: it remained a private credit institution but lost its autonomy. After 1939 the Bank lacked independence and had no objectives other than those set and defined by the Ministry of Finance. All monetary powers were assumed by the government, making the Bank a mere appendix and instrument of the Treasury. In 1939, foreign exchange policy was transferred to a newly created body, the Spanish Institute for Foreign Exchange, and placed under the control of the Ministry of Industry and Trade, detached from the Ministry of Finance. A separation thus emerged between the internal and external sides of monetary policy that lasted until 1971 when the Institute was dissolved. Moreover, Spain was excluded from the Bretton Woods conference, and hence kept out of the International Monetary Fund and the World Bank, a situation that was not reversed until 1958.

Autarchy and extreme economic and financial interventionism were the two main features of the period. In the 1940s GDP stagnated, accompanied by high inflation, while the peseta exchange rate and all foreign transactions on current and capital accounts were subject to strict controls. Interventionism was relaxed after 1951 and in 1953 Spain, which had been excluded from the Marshall Plan, received a significant amount of financial aid under the umbrella of two accords with the United States, one in the field of military defence and the other in the field of economic cooperation. This was followed by a five-year period of rapid industrialisation, during which economic imbalances, such as rising prices, overvaluation of the exchange rate, balance of payments deficits and budgetary imbalances, accumulated. To prevent the economy from coming to a sudden standstill, an all-encompassing stabilisation programme was adopted in 1959, including monetary, fiscal and commercial measures: higher interest rates, strict limits on bank lending, a currency devaluation, a fiscal reform, and public expenditure cuts. Moreover, the inward-looking industrial strategy was replaced by more outward-looking policies: autarchy and administrative interventionism was partially abandoned and Spain was admitted to the OECD and Bretton Woods. At this point, the Banco de España played a significant, and even a leading, role in preparing and conducting the stabilisation programme and the negotiations with international bodies. Monetary policy was revived and the Bank was given new responsibilities and instruments for action. The Banco de España was eventually nationalised in 1962.

The war settlement and the new monetary order

The war settlement took a long three years. After the Civil War, Spain's financial fabric had to be regenerated. This was done according to two principles that were to guide the Spanish economy for the following two decades: autarchy and interventionism. First, the inapplicable precepts of the Banking Law of 1921 were modified, specifically those concerning the metallic backup of fiduciary circulation, since the Bank's metallic reserves had disappeared, and also those relating to the Bank's relationship with the Treasury. To that end, three regulations were approved in 1939 that were to serve as the basis for the new system: a) banknotes were declared to be legal tender, fully acceptable as a means of payment; b) the metallic guarantees for issuance were suspended and restrictions on the Treasury's account with the Bank were lifted; and c) the Bank was authorised to acquire public debt securities and Treasury bonds, which were to become a part of the counterpart for fiduciary circulation. Later, the Financial Unfreezing Law was passed to resolve the situation created by wartime legislation that had left all financial operations undertaken in

areas controlled by the Republican government *sub judice*. The Law restored normalcy in the use of accounts and was based on the principle of removing the par block as long as bank balances did not exceed those of 18 July 1936. Any increments that remained after this initial operation were reduced by establishing the balances at various stages of the war years and applying corrective coefficients to them according to the degree of monetary devaluation registered in the Republican zone. The same principle and coefficients were used to unfreeze asset operations by commercial banks and savings banks deriving from the granting of credits or discounting of bills.

The next step in the process of post-war monetary normalisation was a special Law of March 1942 which determined the settlement of the Banco de España's financial years from 1939 to 1941, merging the balance sheets of the two institutions active during the conflict. This merger signified removing banknotes circulating in the Republican areas from the Bank's liabilities, and eliminating the Bank's gold reserves and advances to the Republican Treasury from its total assets. The Law also introduced other changes: dividends to Bank shareholders were limited and the proportion that went to the State was increased. The so-called *banking status quo* was also part of the financial policy measures adopted after the war. An extremely important ministerial order was issued on 19 October 1939 prohibiting the formation of new commercial banks or savings banks and banning existing institutions from making capital increases, or extending their territorial reach, or even amending their articles of association without government permission.

Post-war legislation was completed with the approval of a new Banking Law in December 1946, formally to address the issue of expiration of the Banco de España's period of banknote issuing privileges. This new Law did not nationalise the Bank, but placed it completely under the control and supervision of the Treasury. The Law also confirmed many of the conditions established by the legal provisions enacted since 1939. Domestic monetary policy attributes were ceded to the Ministry of Finance and, as already mentioned, foreign monetary policy was entrusted to the Spanish Institute for Foreign Exchange.¹ In addition, commercial dealing with the non-banking sector was prohibited. In short, the 1946 Law drastically limited the Bank's autonomy and slowed its progress towards becoming a genuine central bank. It reinforced the Finance Ministry's intervention in the Bank, which lost much of the independence it had enjoyed previously.

Interventionism and regulation

Between the end of World War II and the demise of Bretton Woods, financial regulation became widespread, both at the national and international level, as part of a strategy to avoid the chaos that had characterised international economic relations in the 1930s. During most of the 1950s and 1960s the authorities determined and limited both the direction of lending and its total volume. The commercial banks were, to some extent, co-opted into the public sector, rather like public utilities. There was very little call for supervisory or regulatory activity or skills from the central banks. The few instances in which central banks were asked to help virtually never involved a straightforward case of liquidity shortage, but almost always a mix of liquidity and solvency concerns, usually with the latter triggering the former. Sometimes the solution was an arranged merger.

Spain was no exception to this general trend. The autarchic and interventionist orientation of the early years of the Franco regime prompted the imposition of structural controls and a shift in banking supervision away from market discipline and towards government discretion. Financial stability and government-oriented resource allocation rather than competition became the priority of the authorities. Policy-makers and regulators

¹ Martínez-Ruiz (2000).

were convinced that financial institutions should be subject to strict controls and reoriented to supply whatever funds the “national economy” required. As elsewhere in Europe, the financial market was suppressed and banks became the agents of government industrial policy. The myth of economic planning, coupled with the idea that banking was a special sector where the principles of market freedom had somehow to bow to the “superior” interest of controlling the economy, explain why legislation empowered authorities (essentially Finance Ministries) to impose structural controls.

The Banking Law of 1946 included a litany of regulations. The Ministry of Finance received discretionary powers to grant or deny bank charters. Entry was at the discretion of the Ministry of Finance, which used its authority rather arbitrarily. The era of easy entry came to an end. A new Banking Record Office was established and only existing banks were allowed to register and to continue in the industry. Newcomers had to demonstrate the need for banking services in a specific geographical area. Banks’ capital structure, their potential earnings, their management and the convenience and needs of the community they were to serve were elements the new regulators considered before approving the establishment of a new bank. Furthermore, a favourable report from the *Consejo Superior Bancario* (CSB), also under government control, was needed. Branch expansion depended on the financial density of each region, the existence of unmet financial demand or a proven lack of financial services. The Ministry of Finance set maximum and minimum interest rates on deposits and loans. It also set preferential rates for the “priority industrial sectors”. All banking operations were subject to controls. Portfolio restrictions meant, inter alia, that only discounting and short-term commercial loans with 90 days maturity were authorised. Long-term credit was severely restricted until 1960. Quantitative credit ceilings were imposed according to the industrial policy of the government. The Ministry of Finance also set minimum capital requirements and asset-liability ratios, but no legal cash or liquidity ratios or capital-to-asset ratios. Changes in nominal or paid-up capital, reserve provisions, dividend distribution and exchanges and acquisitions of shares among financial institutions were all subject to ministerial approval.²

The Banco de España’s long siesta

It can be safely said that 1940 to 1957 were the worst years in the history of the Banco de España, as the Treasury Department exerted greater control than ever before.³ There was a complete absence of monetary policy. The Banco de España lacked autonomy and had no instruments at its disposal to regulate the quantity or the cost of money. No open market operations were undertaken and there were no cash or liquidity ratios. Monetary management policy in those years led to the continuous creation of domestic resources at low interest rates. The Bank passively supplied liquidity to the system on a scale and in amounts determined by the Treasury. Interest rates were kept low in order to facilitate the placement of public debt at the lowest possible cost. The Bank had no power whatsoever to intervene in any domestic monetary policy decisions, least of all in any foreign monetary policy decisions such as determination of exchange rates or management of foreign reserves.

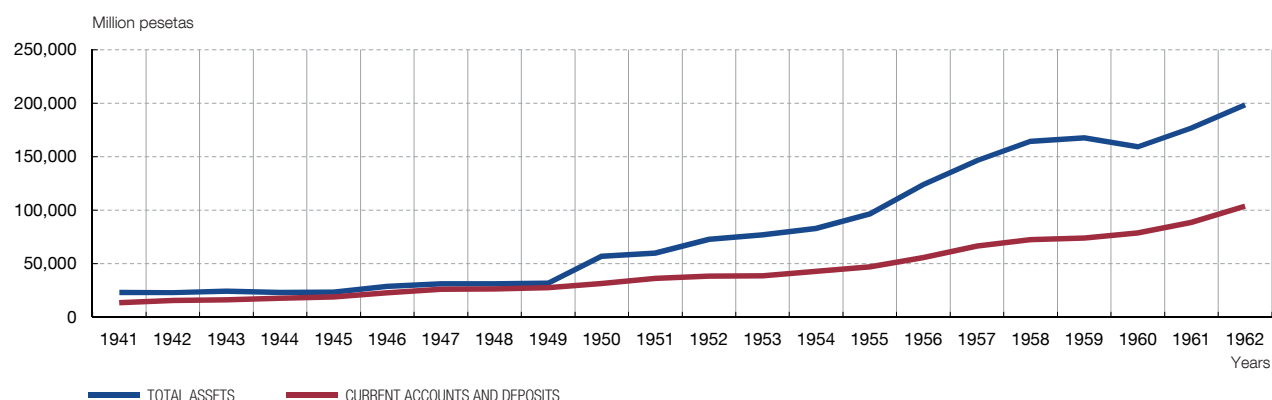
The Bank’s board, dominated by members appointed by the Ministry of Finance, did not discuss monetary matters or even general economic issues. Particularly after 1946, when a heated debate took place over the destructive effects of the prevailing inflationary process, all references to monetary policy disappeared from the minutes of the board meetings. There were two separate sides: on the one hand the members representing private capital, individual shareholders and private institutions; and on the other the members representing the Treasury,

² Lukauskas (1997); Martín-Aceña, Pons and Betrán (2014); Pons (2002); Poveda (2012).

³ Martín-Aceña (2006); Poveda (1980); Rojo and Pérez (1977); Sardá (1970).

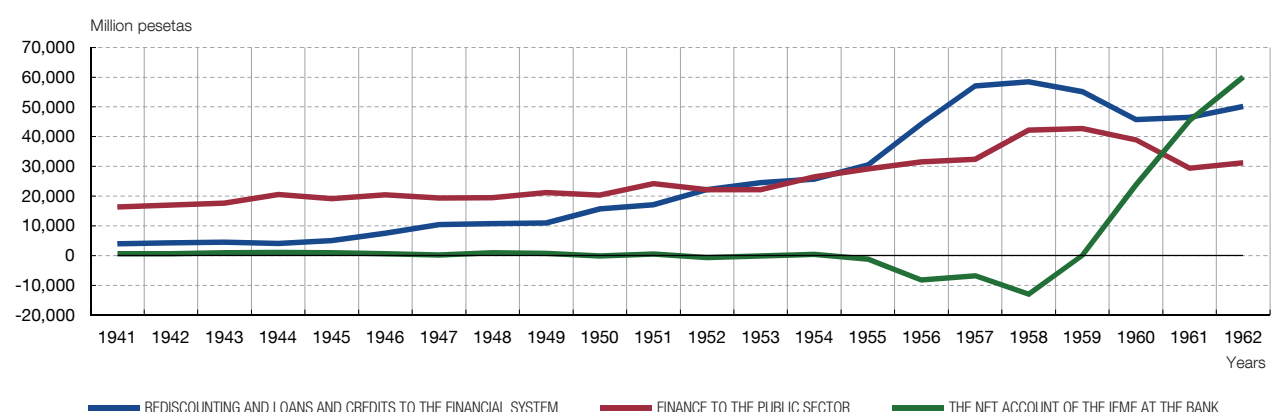
BANCO DE ESPAÑA: TOTAL ASSETS AND BANKNOTES IN CIRCULATION, 1941-1962

FIGURE 7.1

SOURCE: Banco de España, *Memorias anuales*.

BANCO DE ESPAÑA: MAIN ASSETS, 1941-1962

FIGURE 7.2

SOURCE: Banco de España, *Memorias anuales*.

led by the governor and deputy governors. The role of the latter was to impose the recommendations and decisions emanating from the economic authorities. The governor often reminded board members that the Bank should limit its actions to obeying the orders given by the “superior authority”, that is, the Ministry of Finance.

On occasions, shareholders’ representatives complained about the excessive intervention of the Treasury in an institution that was still private. They also asked for the Bank’s capital to be increased, which always met with an official negative response. And they constantly fought for larger dividends to be distributed among the shareholders, also to no avail. The so-called “battle for the dividend” was an issue that caused bitter confrontations between the two sides of the board. The private representatives complained that, although it had not been nationalised, the Bank resembled any other administrative body entirely dependent on the Ministry of Finance.

Figure 7.1 shows the change in total assets and banknotes in circulation in the period. Over the course of these two decades the Bank’s balance sheet multiplied ninefold and banknotes in circulation almost eightfold. Monetary expansion in the 1950s clearly outpaced that of the 1940s. The factors that explain the increase in the Bank’s balance sheet and account for the rapid increase in banknote circulation can be gauged from Figure 7.2. First of all, rediscounting and loans and credits to the financial system. However, this masks

the fact that a large part of the rediscounting consisted of bills belonging to semi-public institutions and firms that had been subscribed previously by commercial banks and savings banks. It also masks the fact, mentioned above, that a large volume of the outstanding credit of the financial system was obtained by placing Treasury bonds and sovereign debt previously issued and subscribed by private credit institutions as collateral with the Bank.

The 1959 Stabilisation Plan and the nationalisation of the Banco de España

This state of affairs continued until 1962 when the regulatory framework created after the civil war was partially altered. Changes in the European financial environment and the exhaustion of the domestic expansionary cycle that began in 1951 convinced the government that the autarchic and interventionist strategy had to be dismantled. The Spanish economy grew at a fast pace during most of the 1950s, but at the same time it built up a series of fiscal and monetary imbalances that threatened to abruptly halt the past economic gains, and even to reverse what had been achieved in terms of income per capita. Protectionism and interventionism had also led to gross industrial inefficiencies and misallocation of resources. In 1959 a Stabilisation Plan, modelled on a similar French plan, was adopted to correct the inflationary process and the mounting balance of payments imbalances. The plan was followed by a series of reforms aimed at dismantling the autarchic framework, reducing the participation of the State in the economy and enhancing the role of the market.⁴

Negotiations to join the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (The World Bank) began in 1958 at the same time as an agreement to enter the OECD was reached. Joining these two organisations led to the abandonment of autarchy and a change in the orientation of Spain's economic policy to align it with that of other European countries. Immediate measures were taken to correct the imbalances: a tax reform to raise revenues, a halt to the issuance of government debt, automatically pledged to the Bank, and steps to limit budget expenditure. The Stabilisation Programme was approved in the summer of 1959. The fact that monetary policy was conducted by the Banco de España was paramount in the successful elimination of the economic and financial imbalances. The Bank's interest rates were raised, ceilings on bank loans and credits were introduced and certain liquidity ratios were adopted. Furthermore, the multiple exchange rate structure was eliminated, the peseta exchange rate suffered a sharp devaluation and limited convertibility was declared within the framework and rules of the IMF. Other significant measures were the approval of a new tariff and the partial liberalisation of foreign investment. All of this put an end to two decades of State interventionism and economic isolation.

Figure 7.1 and especially Figure 7.2 show the effects of the 1959 Stabilisation Programme. The introduction of monetary and fiscal restraint reduced the Bank's outstanding credit and slowed down the growth of banknotes in circulation. The devaluation of the peseta stimulated exports and diminished imports, bringing about a radical change in sign on the balance of payments on current account. The accumulation of foreign reserves in the Spanish Institute for Foreign Exchange was the only positive factor contributing to the expansion of base money, which compensated for the contractionary effects of the other two.

The Stabilisation Programme and, in particular, the success of the monetary policy measures taken and the significant role played by the Banco de España, brought to the fore the need for a reform of the financial framework. It was three years, however, before the government decided to undertake the task, but in the end a new Banking Law was drawn up, approved in 1962. The law nationalised the Bank and provided the foundation

4 González (1979).

for its transformation into a genuine central bank. Its preamble included a phrase that echoed the ideas of the 1921 Law: “despite its historical role as the government’s banker and as an issuing institution, the Banco de España is not yet a bank of bankers, or the central regulator of the credit mechanism, or the institution responsible for exchange rate policy”. As in 1921, the authorities recognised that the Banco de España had not been and was not yet a real central bank. The 1962 Law aimed, in theory, to correct this state of affairs. However, its content did so only in part.

The Bank was not given full autonomy; monetary policy remained in the hands of the Ministry of Finance and the formulation of monetary targets, if any, was not the Bank’s responsibility. Moreover, although the Ministry ceded the instrumentation of the corresponding policy to the Bank, it was not given the mechanisms to carry out its functions. No cash or liquidity ratios were established, nor the framework to undertake open market operations, and, in particular, the discount rate continued to be controlled by the Ministry of Finance. Neither foreign exchange policy nor foreign reserve management were assigned to the Bank until the end of 1969, when the operational functions of the Spanish Institute for Foreign Currency (IEME) were transferred to it. The 1962 Law entrusted the Bank with the task of inspection and supervision of the financial system. However, the Bank also had to share these functions with other bodies. In fact the Ministry of Finance maintained its fully comprehensive powers over the financial system; the Banco de España lacked autonomy and continued to implement monetary policy, if at all, as a mere instrument of the government.⁵

⁵ Martín-Aceña (2006) and Poveda (1980).

The European economic golden age was shared by Spain. Growth was particularly rapid between 1962 and 1973 and Spanish GDP moved closer to the levels observed in the most developed countries of continental Europe. There were also economic and financial reforms, but they proceeded at a slow pace and, as in the previous period, imbalances built up. Interventionism did not disappear entirely and was concentrated, in this period, on capital and labour markets and in some industrial sectors selected by the government to receive public and private investment. Obligatory investment ratios imposed on commercial banks and savings banks were the means by which financial funds were directed to specific sectors. Monetary policy, still under the control of the Ministry of Finance, was used sporadically. The Bank's role was simply to supply the economic system and the Treasury with abundant liquidity at minimum cost. The nationalisation of the Bank in 1962 did not lead to a modern monetary policy; instead, monetary instruments were used to resolve occasional problems.

Franco died in November 1975 and the transition to democracy that began immediately afterwards coincided with a deep industrial and banking crisis. The resolution of the crisis took time and radical measures had to be adopted to modernise the economic fabric of the country. The role of the Banco de España in the process was paramount. The Treasury focused on budgetary and fiscal issues and central banking functions were transferred to the Bank, which became, *de facto*, the monetary authority. Once the political transition was complete and the crisis surmounted, Spain joined the then European Economic Community (EEC) in June 1985. The ensuing years were characterised by growth, structural reforms and adjustment to EEC regulations at all levels. Spain signed the Maastricht Treaty in 1992 and joined the European Monetary System in 1993. Reforms and growth continued once the painful 1992-93 crisis was overcome. Six years later, in January 1999, Spain was one of the founding countries of European Economic and Monetary Union (EMU).

The Banco de España's role changed profoundly over the last four decades of the 20th century. It became a major player in the conduct of the economy and eventually assumed all the functions pertaining to a modern central bank: the agent responsible for monetary policy, broadly defined, and the lender of last resort. There were several benchmarks in this transformation. In 1971 the Bank's inspection functions were expanded when a Royal Decree of the Ministry of Finance implementing the Law on Organisation and Regulation of the Official Credit Institute entrusted the Bank with the supervision of savings banks and credit cooperatives. In 1973 the Institute for Foreign Exchange was closed and its functions transferred to the Bank. In 1980 the Law on the Governing Bodies of the Banco de España conferred upon the institution a substantial degree of autonomy, from both a hierarchical and a functional standpoint (e.g. with respect to monetary policy). The Law on Discipline and Intervention of Credit Institutions of 1988 set out the supervisory function of the Bank and extended it to all credit institutions (commercial banks, savings banks, credit cooperatives and specialised lending institutions) both inside and outside Spain and, with limited responsibilities, to the branches of EU banks operating in the country.

A particular landmark was the Law of Autonomy in 1994 which finally made the Banco de España fully responsible for monetary policy, guaranteeing its independence from the government. The final impulse for the formal recognition of this autonomy was provided by the European Monetary Union project, as it was understood that candidate countries should have central banks independent from political power. The Law of

Autonomy considerably altered the Banco de España's relationship with the government, prohibiting it from extending finance to general government and limiting it to informing the government of monetary policy targets and conduct, without requesting or accepting instructions from the government or from any other domestic or EU body. It also established quite long, non-renewable mandates (six years) for the Bank's governor and deputy governor, and strictly defined the possible causes of their removal from office.

In 1994 the Banco de España joined the European System of Central Banks (ESCB), of which it is a member along with the national banks of the other European Union Member States and the European Central Bank (ECB). The final preparations for the launch of the European single currency were already under way and, on 1 January 1999, the euro became the currency of eleven EU Member States, including Spain. Since that date the founding members of the Eurogroup have used the new currency as their unit of account and have shared a common monetary policy. Monetary policy decisions aimed at maintaining price stability are made by the ECB's Governing Council, on which the governors of the national banks of the Eurogroup sit.

Throughout these years of transformation, the challenges faced by the Banco de España were no minor matter. First, a protracted and complex banking crisis that began in 1977 and was not fully resolved until 1985. Second, the need to acquire the necessary instruments for monetary management while simultaneously leading the deregulation of the financial system. Third, the assumption of the external side of monetary policy, that is, exchange rate management. Fourth, monetary policy strategy, i.e. setting the Bank's monetary targets. And last, preparing the economy to fulfil the conditions imposed by the Treaty of Maastricht for EMU membership.

Banking crisis and financial reforms

With the collapse of the Bretton Woods system, financial crises returned to the world scenario with a vengeance. Indeed, by the end of the 1960s, the old system of centrally directed uncompetitive banking was coming to an end. The removal, or avoidance, of exchange controls was leading to greater global competition in finance. Information technology was also spurring competition. Equally importantly, the academic fashions of the age were changing, with competition coming to be regarded as preferable to central coordination as a spur to efficiency and growth. In this setting, financial crises made a frightening return. In many countries these crises had their origin in a previous cycle characterised by excessive real estate investment, rapid credit expansion and exceptional increases in asset prices. A permissive factor was the domestic financial deregulation that began in the late 1970s and was completed by the late 1980s. When the boom ended, bankruptcies and widespread financial instability ensued. Having dismantled the safeguards provided by the post-war structural controls but not yet set in place the new prudential instruments, the authorities were taken aback and were forced to design a new architecture of financial regulation, a task that would be undertaken in the 1980s and would take time to implement.¹

Once again Spain was no exception. The late 1970s and early 1980s saw the most severe financial crisis since the crash of 1866. No less than 24 institutions were rescued, four were liquidated, four merged and 20 small and medium-sized banks were nationalised. All in all, 52 banks out of 110, accounting for nearly 25 per cent of the system's deposits. By virtue of its depth and the number of institutions affected, this crisis is included in the group of the recent "Big Five Crises". Savings banks also went through difficult times, although in this case consolidation was the solution adopted to prevent major bankruptcies.

1 Asociación Española de la Banca (1983); Betrán and Pons (2017); Cuervo (1988); Martín-Aceña (2013); Poveda (2012).

In many instances, insolvent small and medium-sized savings banks were absorbed by larger and better managed institutions. The resolution of the banking crisis imposed a high fiscal toll on the economy. The total gross fiscal cost of the rescue operations was approximately 5 per cent of GDP, estimated to be equivalent to the fiscal cost of the industrial restructuring that took place at the same time. Although conditioned also by other elements, the deficit multiplied by a factor of 50; from a mere 0.5 per cent of GDP in 1975 it rose to more than 6 per cent in 1984 and 1985. Credit to the private sector fell sharply, from an annual growth rate of 25 per cent at the beginning of the crisis to a low of 1.4 per cent in 1984. Moreover, shareholders and creditors of the banks placed under public administration incurred heavy losses.

A combination of exogenous and endogenous factors was behind the banking crisis. In the mid-1970s the stable macroeconomic environment of the previous decade came to an end. Energy, raw material and labour costs all rose. The balance of payments on current account deteriorated, inflation escalated and nominal interest rates increased. Unemployment rose to record levels of 25 per cent. The industrial sector was severely hit as well. Low demand combined with increasing costs reduced the profitability of firms. Technical obsolescence, a lack of competitiveness and reliance on external finance complicated matters for industrial companies. Firms in sectors such as mining, iron and steel, shipbuilding and machinery experienced heavy losses and many had to close their doors. Consumer goods industries also went through difficult times. Banks caught with large industrial portfolios saw their balance sheets deteriorate. The volume of non-performing assets rose. Bank profits declined and in some cases losses were recorded, although they were not publicly unveiled. Equity prices fell sharply, as did housing and commercial real estate prices after several years of a pronounced upward trend supported by high borrowing levels. By around 1980 non-financial sector indebtedness had reached a historical high with a leverage ratio close to 100 per cent.

Deregulation and competitive pressures were other causes of the banking crisis. Between 1974 and 1982 the banking system underwent a continuous, albeit slow, process of liberalisation. Many of the previous restrictions on banking operations were lifted and interest rates were deregulated. Savings banks were allowed to expand geographically and into business areas hitherto prohibited. There was also rapid expansion in the number of branches of existing commercial banks. Competition from foreign-owned banks after 1978, and from credit companies, insurance companies and, in particular, finance companies also intensified the competitive environment.

The end of the status quo and the dismantling of the structural controls after 1962 was ill prepared and poorly conducted. The separation between commercial and investment banks failed, the paid-up capital required to establish new credit institutions was set at very low levels and plans for new branch openings made no economic sense, leading to an oversized network. Many banks expanded into geographical and business areas of which they had little prior knowledge. Industrial banks set up after 1962 lacked expertise and qualified professionals. Bank management was not used to operating in a competitive environment and continued to focus on gaining market share. Problems accumulated as a consequence of thin capitalisation, excessive risk concentration (over the legal limits), high leverage to sustain uncompetitive firms under the control of the banks and unorthodox accounting methods to mask solvency difficulties, when not outright illegal financial operations.

As the banking crisis erupted almost unexpectedly, both the Ministry of Finance and the Banco de España were caught unprepared. Deregulation had not been accompanied by the establishment of an efficient system of banking supervision. The authorities had neither the legal instruments nor the institutional arrangements to face the turmoil caused by the large-scale bank insolvencies. Although since 1971 the Banco de

España had assumed all inspection functions of all credit institutions (except the State-owned banks), its inspection division lacked the human resources to carry out adequate banking examination. Disclosure requirements for financial holdings were not in place, so it was difficult to gauge the solvency of the financial firms within them. Auditing of banks was not at the time a widespread custom and many firms resisted inspection by outsiders. Procedural rules to impose sanctions on managers or to remove directors of troubled banks were legally complicated, outdated or non-existent. To avoid a catastrophe, the Bank had to implement emergency measures to prevent bank runs and a contagion effect from unsound to essentially solvent institutions. Containment included lender of last resort assistance to banks with temporary liquidity problems and seizing control of banks that had basically failed.

To provide limited guarantees to depositors, two Deposit Guarantee Schemes (one for commercial banks and another for savings banks) were established in November 1977. Rescue operations began in 1978 and continued well into 1983. A new institution was set up with the name *Corporación Bancaria*, a private joint-stock company that received contributions from the Banco de España and from nearly one hundred banking firms. It proved to be a speedy and appropriate mechanism for taking control of troubled banks, removing and replacing their directors, reorganising the banks and, in due time, returning them to the private sector. In 1980 the Deposit Guarantee Schemes were reorganised, replacing *Corporación Bancaria* and with additional power and financial muscle. They took over 29 institutions, of which only one was liquidated, while the rest were restructured and reorganised before being sold on to other banks.

The resolution of the banking crisis was followed by a period of intense financial restructuring. Commercial banks reduced their industrial portfolios, whose share in the balance sheets declined from 33 per cent of total assets in 1975 to 13 per cent by 1986. By contrast, holdings of public securities increased. Financial concentration was also an outcome of the crisis. Mergers were made as the result of public policy recommendations and for purely economic reasons. Consolidation accelerated in the late 1980s and early 1990s.

The crisis taught important policy lessons and the regulators moved swiftly to forge a strong banking supervision regime. They realised: first, that bank regulatory and supervisory agencies needed adequate resources in order to do their job effectively; second, that proper accounting standards and disclosure requirements are crucial for a healthy banking system; third, that bank supervisors need to take prompt action to stop undesirable bank activities and even close down institutions that do not have sufficient net worth, while ensuring that stockholders and managers of such insolvent institutions are appropriately punished; and fourth, that because prompt corrective action is so important, a bank supervisory agency needs to be sufficiently independent from the political process so that it is not encouraged to sweep problems under the rug by engaging in regulatory forbearance.

While the crisis unfolded, legislation was passed to reinforce the Bank's supervisory capacity. In 1980 the Law on the Governing Bodies of the Banco de España transferred all responsibilities for bank supervision, discipline and sanctions to the central bank, which at the same time was given ample political autonomy. Shortly afterwards, by means of ministerial orders or simple communications, the Bank introduced new rules regulating accounting practices and disclosure standards with regard to the profit and loss account. The distribution of profit, the classification of risk according to the nature of each asset, the provision against future insolvency and balance sheet valuation standards were the subject of special attention. Spain's entry into the then European Community after 1986 was an additional force to intensify the reforms and strengthen not only the supervisory framework but also the capacity and

performance of the institutions in charge of the tasks, in most cases the central banks. In 1988 the Law on Discipline and Intervention of Credit Institutions unified the control of all financial firms under the Banco de España. The law regulated the causes for bank intervention, graded the possible infringements, established the standard procedures for banking examination and listed the sanctions for banks and management according to the severity of the offences. The next step was the Law of Autonomy of the Banco de España, which was enacted in 1994 to comply with EU legislation. And lastly, in 2000, the Bank introduced forward-looking provisioning, also known as the dynamic or statistical reserve, which was a way of provisioning in advance for loan losses through the cycle. From the moment that a loan is granted, and before any impairment on this specific loan appears, there is a positive default probability (no matter how low it might be) following a statistical distribution with an expected loss. As the risk appears at the beginning of the operation, so does the statistical provision requirement. With this system, provisions run in parallel to revenues and are, therefore, distributed through the cycle, allowing for a better mapping between income and costs in the profit and loss account. The merit of this system, according to the Spanish authorities, is that it introduces incentives for better risk management, while at the same time attenuating the cyclicity of the financial sector and, therefore, swings in the real economy.

The Banco de España and the return of monetary policy

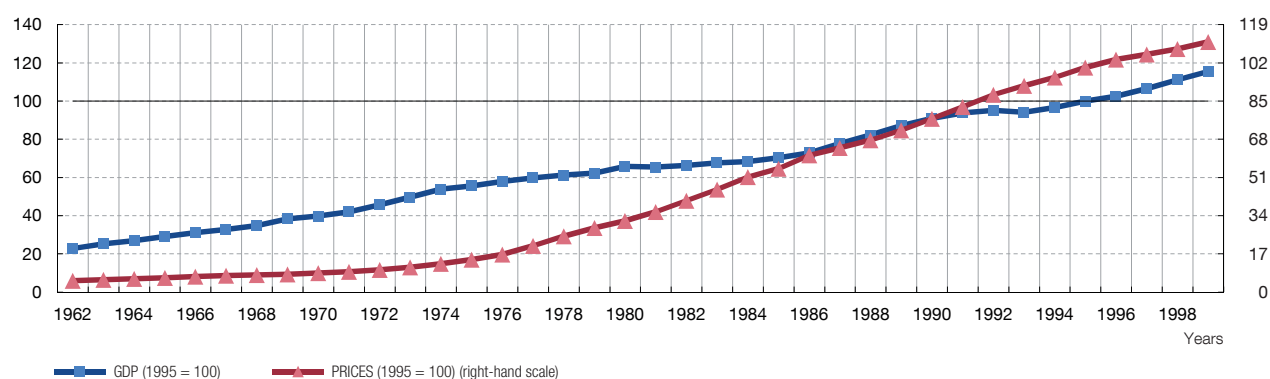
The crisis of the early 1970s, with the sharp increase in oil prices and the collapse of Bretton Woods, marked monetary policy's return to the forefront. Governments in Western Europe and elsewhere, although with delays, stood ready to combat inflation and rising unemployment with all the macroeconomic instruments at their disposal. Monetary policy, which had been banished from view for a long time, was called on to head the response. Nor was Spain an exception on this occasion.

The Spanish crisis coincided with the death of Franco in November 1975 and the ensuing political transition to democracy, which in turn brought about a change in the senior officers in charge of economic affairs at the Treasury and the Banco de España. The economists in both institutions realised that the country, immersed as were other nations in a profound crisis, was particularly burdened by severe domestic and foreign imbalances accumulated during the previous decade. In addition, they believed that inflation was essentially a monetary phenomenon.

The combination of political change, the threat that the crisis might severely shake the economic fabric of the country and the desire to approach the European Economic Community, which entailed dismantling the interventionist administrative apparatus, provided a unique opportunity for reform. For the Banco de España it was also an opportunity to regain autonomy and take control of monetary policy. Officials at the Bank realised that if they wished to replace the old passive monetary stance with active economic management, they would have to have adequate monetary instruments and good statistical information.²

The first step was to develop a macroeconomic model to observe the behaviour and relations of the main magnitudes. The second step was to design a monetary management system. GDP and inflation were the two ultimate monetary policy targets. The monetary system designed had two levels or phases, each with a goal to be attained. For the first level the monetary aggregate chosen was M3, that is, a broad definition of money supply, assumed to be closely related to GDP and prices. For the second the Bank selected an intermediate monetary goal, liquid assets in the hands of the public (a variety

2 Banco de España (1997); Malo de Molina and Pérez (1990); Martínez Méndez (1981); Rojo and Pérez (1977).



SOURCE: Banco de España, *Informes anuales*.

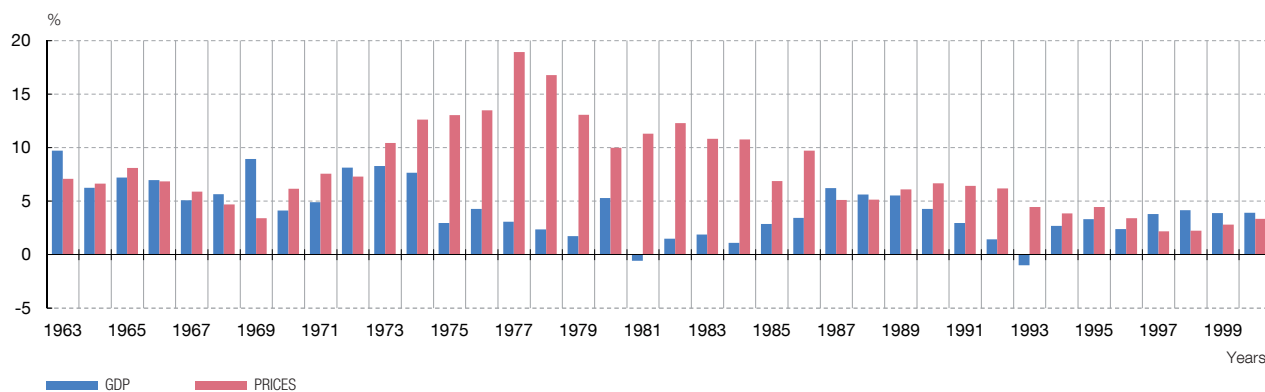
of high-powered money), also assumed to be closely linked in this case to M3. By managing the intermediate or instrumental magnitude they expected to be able to control M3 and eventually GDP and prices. Interest rates and the volume of bank credit were ruled out as intermediate instruments because the Bank doubted its technical capacity to effectively manipulate any of them. Besides, there were estimations that supported stable classical money demand functions in which M3 was the most significant argument.³

This system of monetary control worked well for nearly two decades. The major threat to its operation came from the continuous budget deficits that the Treasury was unable to finance save by resorting to the Bank. To avoid interference with monetary policy, together the Bank and the Treasury introduced reforms to create a monetary market hitherto nonexistent. Once that market was developed, the Treasury was able to cover its budget imbalances by issuing debt in the market at competitive rates, rather than by placing securities with the Bank or through obligatory coefficients for commercial banks and savings banks.

A second challenge to the system emerged in the mid-1980s, with the increasing variability of interest rates as a consequence of the strict control exercised over M3 and the increasing volatility of the exchange rate which became a matter for concern. The Bank decided to pay attention to both variables in order to smooth their fluctuations. Indeed, when Spain joined the European Exchange Rate Mechanism in 1989, the peseta exchange rate became paramount. This coincided with a change in policy thinking that led to the belief that exchange discipline, more than domestic fiscal or monetary policy, was sufficient to guarantee price stability. The monetary storm of 1992 undermined this belief. The peseta was devalued along with pound sterling, the Irish pound and the lira and the obsolete monetary system based on instrumental monetary variables had to be adjusted and replaced with one based on direct inflation goals. In this instance, the opportunity came with the Maastricht Treaty of February 1992 and the establishment of the criteria for joining the future Economic and Monetary Union.

The Law of Autonomy of the Banco de España was passed in 1994. Consistent with Article 108 of the Maastricht Treaty, the institution was granted full autonomy in the field of monetary policy with the goal of maintaining price stability. Hence, beginning in 1995, the Bank abandoned its traditional monetary policy system, swapping it for an

³ Interest rates and the volume of bank credit were ruled out as intermediate instruments because the Bank doubted its technical capacity to effectively manipulate any of them. Besides, there were estimations that supported stable classical money demand functions in which M3 was the most significant argument.



SOURCE: Banco de España, *Informes anuales*.

inflation targeting strategy. Besides, the Bank's policy over the following five years was to ensure that the country satisfied the inflation and exchange rate criteria for EMU membership from the outset.

Figure 8.1 shows how GDP and prices evolved over the period analysed, and Figure 8.2 the annual percentage changes. Prices clearly rose faster than total output from 1973, when the Bank did not yet have monetary control. The 1980s and 1990s show the opposite picture. Annual fluctuations in GDP were sometimes quite dramatic, but prices fell throughout. Appraised by this indicator, the Banco de España's policy aimed at reducing inflation was successful. The full assumption of central bank functions and full autonomy since 1994 had been worthwhile.

European Monetary Union (EMU) came into being in December 1999. Having fulfilled the convergence criteria laid down in the Maastricht Treaty, Spain became part of the euro area along with ten other EU Member States. The changeover was based on a conversion rate of 166.386 pesetas per euro, as irrevocably fixed in December 1998. For the first three years, the euro remained an invisible currency, only used for accounting purposes and in electronic payments. Coins and notes were introduced on 1 January 2012.

The Banco de España became a member of the Eurosystem, the central banking system of the euro area, which comprises the ECB and the national central banks of the euro area countries. The framework defined for monetary policy in the newly created common currency area was a compromise between various national traditions (which had arisen from specific characteristics of national banking and financial systems) and the international consensus on optimal monetary policy propagated in the 1990s. The consensus hinged on combining a price stability objective with an independent role for the central bank.

Joining the euro brought about fundamental changes in the institutional framework in which monetary policy decisions were made, meaning that the Banco de España also had to redefine its duties and position in national and European economic policy-making. So participation in the Eurosystem led to changes, but not necessarily to a reduction in tasks. Since 1 January 1999, the Bank has assumed two basic functions, one as a member of the Eurosystem and the other as a national central bank.¹

The first function includes: defining and implementing the Eurosystem's monetary policy, with the principal aim of maintaining price stability across the euro area; carrying out foreign exchange transactions consistent with the provisions of Article 111 of the Treaty of the European Union, and holding and managing the State's official currency reserves; promoting the proper working of payment systems in the euro area; conducting emergency liquidity assistance (ELA) operations; and issuing legal tender banknotes. The functions as a national central bank encompass holding and managing currency and precious metal reserves not transferred to the ECB; promoting the proper working and stability of the financial system and, without prejudice to the functions of the ECB, of the national payment system, with particular reference to ELA operations; supervising solvency and compliance with the specific rules of credit institutions, other entities and financial markets, for which it has been assigned supervisory responsibility; placing coins in circulation and performing, on behalf of the State, all such other functions entrusted to it in this connection; preparing and publishing statistics relating to its functions and assisting the ECB in the compilation of statistical information; providing treasury services and acting as financial agent for government debt; and advising the government, and preparing the appropriate reports and studies. Therefore, while monetary policy is decided at ECB level, the national central banks are responsible for implementing that common policy. This means that the Banco de España and the other Eurosystem national central banks continue to have important operational duties.

In addition, integration in the Eurosystem triggered a series of transformations that, beyond the requirements for Europe's monetary integration process, profoundly altered all areas of the Bank's activities. The instrumentation of monetary policy was modified to adapt it to that established by the Eurosystem. For instance, the integration of the peseta into the

¹ Gil (1985, 2006).

euro in 1999 changed the functions of operating and promoting financial markets typical of a central bank. The Banco de España maintained a tradition of frequent interventions in currency markets and active monetary instrumentation based on a permanent presence in domestic interbank markets, adding or removing liquidity. By contrast, the ECB allowed the euro to fluctuate freely on the exchange markets and began to instrument a more regulated monetary policy based on periodic auctions of liquidity and permanent credit and deposit facilities. Also, in response to both the limited presence of the Eurosystem on exchange markets and the reduced need for foreign currency to defend the peseta's parity, the Bank modified its balance sheet and reduced its currency holdings. It also increased its portfolio of euro bonds, which already represent the most substantial part of its balance sheet assets.

Moreover, the entry into the euro made it necessary to embark on a profound reform of the systems of payment and settlement of securities that the Bank had promoted during the last 15 years of life of the peseta. In order for the euro to begin functioning, and to produce perfect interest rate arbitration, the high-value payment systems of the 12 member countries had to be integrated. In order to make this possible, the TARGET (Trans-European Automated Real-time Gross settlement Express Transfer) system was created, linking together the treasury accounts of the banking system operating in all of the central banks of the Eurosystem.

The Bank's participation in the ECB is articulated through several channels. The governor, as a member of its management bodies, participates in the decision-making process at the ECB board meetings held every two weeks and at the General Council meetings held every quarter. Decisions concerning official interest rates deserve a special mention here in view of their importance; as a general rule, these decisions are made at the first meeting of each month.

Although supervisory and regulatory tasks were not originally part of the functions transferred to the ECB, they do have a presence there because of their pertinence to the Banking Supervision Committee and its participation in the elaboration of the ECB's Financial Stability Report. Both functions have undergone important changes owing to the reforms taking shape in the European regulation and supervisory structures.

Moreover, in the purely domestic setting, there have also been changes worthy of note. For instance, the introduction of risk-based banking supervision, complementing the Bank's traditional methodology, which is very intense in terms of verification and comparison of information and interacts perfectly with the implementation of the Basel II Capital Accord. The growing cooperation and exchange of information taking place within the European Union also has visible effects in the national sphere, and in this respect the Bank has signed Cooperation Protocols with other national supervisors, the National Securities Market Commission (CNMV) and the General Insurance Office, and with the Money Laundering Prevention Service (SEPBLAC).

Meanwhile, from the regulatory standpoint, the process of adapting the Accounting Circular to the new international accounting standards (IAS) has been fundamental. It has involved considerable respect for the Bank's accounting philosophy, making it possible to avoid subjecting credit institutions to multiple standards of this type. Moreover, special attention is being paid to transparency in all of the Bank's activities.

Spain in EMU: from economic prosperity to economic recession²

In addition to the challenge of adapting its functions and organisation to EMU, the Banco de España faced even more testing issues. The first years of EMU saw uncontrollable

² This section summarises a large body of literature on the topic. See, among others, Banco de España (2001, 2005, 2010, 2011); Estrada et al. (2009); Malo de Molina (2005, 2011, 2012); Ortega and Peñalosa (2012); Poveda (2012).

Average annual rates

	GDP		Population		Per capita income	
	1990-1998	1999-2007	1990-1998	1999-2007	1990-1998	1999-2007
United States	3.0	2.7	1.2	1.0	1.7	1.7
EU-3 (a)	1.5	1.7	0.4	0.3	1.1	1.4
Euro area	2.1	2.2	0.4	0.5	1.7	1.7
Spain	2.7	3.7	0.2	1.4	2.5	2.4

SOURCES: Banco de España and Eurostat.

a EU-3: Germany, France and Italy.

economic and financial expansion, which was followed by a severe financial crisis that began in 2007 and has not yet ended. The Bank has been criticised for both the excesses of the growth phase and the resolution policy implemented to solve the crisis.

The Spanish economy was among those that reaped most benefit from EMU membership. During the first seven years of monetary union, Spain's economy enjoyed a sustained growth phase in which real convergence with the core EMU member countries advanced: GDP per capita relative to the EMU average increased by more than 15 percentage points (pp), from 79 per cent to 95 per cent. Table 9.1 shows the average growth rates of GDP, population and per capita income between 1990 and 1998, and in the nine subsequent years, from 1999 to 2007. Comparison with the performance of other countries – the United States, the three biggest euro area members (Germany, France and Italy) and the euro area itself – offers a first impression of the potential impact of EMU on the performance of the Spanish economy. Significant factors behind the expansion of economic activity in the second period were the remarkable demographic increase (mainly owing to a huge influx of immigrants) and the change in the macroeconomic regime as a result of the Spanish government's determination to join EMU from the start.

A key factor in the growth of economic activity over the decade was the real estate boom. The expansion was driven by the availability of abundant credit and unskilled labour. EMU membership entailed a notable reduction in interest rates and increased availability of loanable funds that gave previously excluded groups access to housing and boosted second-home purchases. The buoyancy of credit was particularly intense in sectors such as construction where it is easy to provide an asset as collateral. Yet although supply responded swiftly, it was not sufficient to prevent a considerable climb in house prices from 1999. As a result, housing became one of the most profitable and attractive assets, which boosted investment demand and led to over-expansion of the sector. At the height of the boom, there were more than 800,000 housing starts per year in Spain, more than in Germany, France and Italy combined.

However, the growth of the Spanish economy in the 1999-2007 period was based on foundations that could not be maintained indefinitely. The demand stimulus provided by EMU membership was only partially accommodated by the expansion in domestic output, based on an exceptional increase in the rate of employment. But this was not adequately matched by higher productivity, since the capitalisation of the economy failed to provide for convergence on the levels prevailing in the more developed countries and efficiency gains were not sufficient. Hence a series of imbalances began to emerge in the period, undermining the dynamism of the expansion. Three main imbalances accumulated: an inflation differential; an increasing trade deficit owing to a pronounced loss of external competitiveness; and growing household and corporate debt.

Average annual rates

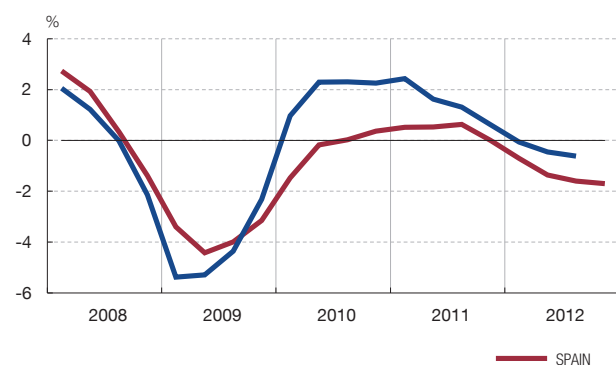
	2006	2007	2008	2009	2010	2011	2012
GDP	4.1	3.5	0.9	-3.7	-0.1	0.7	-1.3
Private consumption	4.0	3.5	-0.6	-4.3	0.8	-0.1	-1.9
Gross investment	8.0	4.2	-4.2	-16.5	-6.5	-5.2	-8.7
Exports	6.7	6.7	-1.0	-10.4	13.5	9.0	3.3
Imports	10.2	8.0	-5.2	-17.2	8.9	-0.1	-5.5
Employment rate	3.5	3.0	-0.2	-6.5	-2.6	-2.0	-4.3
Unemployment rate	8.5	8.3	11.3	18.0	20.1	21.6	25.0
Consumption price index	3.5	2.8	4.1	-0.3	1.8	3.2	2.4
Price differential with EMU	1.4	0.7	0.9	-0.5	0.4	0.3	-0.1

SOURCES: Banco de España, *Annual Report*, 2011, and *Economic Bulletin*, January 2013.

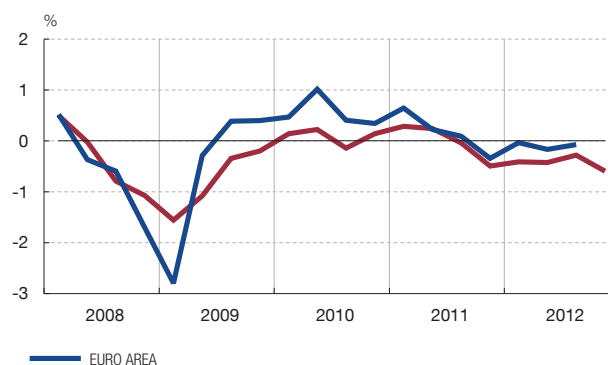
GROSS DOMESTIC PRODUCT (a)

FIGURE 9.1

YEAR-ON-YEAR RATE OF CHANGE



QUARTER-ON-QUARTER RATE OF CHANGE



SOURCES: European Central Bank, Instituto Nacional de Estadística and Banco de España.

a Seasonally adjusted series.

The reason for the inflation differential with respect to the rest of the euro area was the growth in unit labour costs, over and above productivity gains, and in gross profit margins, which suggests that neither has fully adapted to the demands of membership of a monetary union. The inflation differential was also a result of the excess aggregate demand that the Spanish productive system could not meet. As a consequence of the trade imbalance and the excess demand, the nation's net borrowing rose, up to 10 per cent of GDP. Initially, financing the external deficit posed no problems since the country-risk premium practically disappeared and Spain was able to obtain more financial resources than were needed to cover its domestic requirements. But in 2007 the international economic atmosphere changed.

The trigger was the financial crisis that erupted in the United States and Europe in mid-2007. The crisis did not take long to affect the Spanish economy, although the authorities failed to recognise it. The recession began in the third quarter of 2008 and continued, in its first phase, until the end of 2010, making for ten consecutive quarters of decline, with an accumulated fall in total output of around 5 per cent (see Table 9.2 and Figure 9.1). Private consumption declined by 4.1 per cent and investment demand, both in equipment and construction, by 13.4 per cent. The first part of 2011 saw a sluggish recovery, which endured for no more than nine months, after which production fell again.

The contraction lasted throughout 2012 and by the end of that year GDP had shrunk by a further 1.3 per cent. Behind this decline was a fall in all components of aggregate demand, except in exports which cushioned the contraction in output. The employment adjustment was virulent and protracted: the decline began in early 2008 and continued apace until 2012. From growing at a rate of more than 3 per cent before the recession, it fell at rates of nearly 7 per cent per annum, so that by the end of 2012 unemployment had reached an historical high of 25 per cent.

In the particular case of Spain, the crisis had two focal points: the first domestic and related to the excesses accumulated during the expansion; and the second external and due to the effects of the successive international financial shocks dating back to July 2007.

As regards the domestic origin of the crisis, the greater availability of credit due to EMU membership and the over-optimistic expectations of rapid per capita income growth led Spanish households and firms to take on debt briskly. When, following this initial situation, growth expectations became more realistic and credit conditions tightened, consumption and investment decisions had to adjust sharply to correct a debt dynamic that proved to be unsustainable. Given the focus of spending and debt on acquiring real assets, which had pushed real house prices and residential investment sharply higher, beyond long-term sustainable values, this adjustment also brought about a considerable curtailment of construction activity and the reallocation of substantial productive resources to other sectors.

This correction, in itself sharp enough given the scale of the imbalances built up, was magnified by the consequences of the serious international financial crisis, which led to a widespread rise in financing costs for final borrowers and triggered a deleveraging of financial institutions, with the resulting notable global credit shortage. These conditions dramatically altered the world growth scenario, pushing most economies, especially the more developed ones, into deep recession. The financial crisis acted through various channels to accentuate the slowdown in consumption and investment and led, quite swiftly, to a recession in the second half of 2008. The worsening of the financial crisis in the last quarter of that year added deep contractionary shocks to consumer and business confidence, and tightened and restrained credit conditions for agents heavily reliant on borrowed funds. Furthermore, the global nature of the recession deprived the Spanish economy of the support of external demand, which under normal conditions could have been relied on to soften the impact that the necessary adjustment of domestic demand would have on growth.

Spanish banks were relatively unscathed by the first wave of the financial crisis, as they had no direct or indirect exposure to toxic assets. This was the result of the retail orientation of their business model, and of strict banking supervision which had not allowed investment in these products through off-balance-sheet vehicles. Moreover, although Spanish institutions had drawn extensively on wholesale markets to bridge the gap between credit and deposit growth, the bulk of their liabilities were long-term, which made their short-term refinancing needs manageable. Institutions were able to temporarily accommodate part of their financing needs by issuing short-term securities, the market for which had been comparatively less affected. Subsequently emergency measures such as guarantee programmes for securities issues, introduced by the Spanish government, in line with the measures agreed at global and European level, helped facilitate the issue of securities, while the policy of large-scale injection of liquidity by the Eurosystem eased short-term tensions.

In the end, however, the spread and deepening of the financial crisis in the autumn of 2008 with the bankruptcy of Lehman Brothers triggered a major global recession, closely linked to the deterioration in confidence, the impact of declining asset values and tighter credit supply. The second wave of the economic and financial crisis affected Spanish

institutions more powerfully due to the deterioration of their loan portfolios in the wake of plummeting economic growth and employment and the sharp correction in domestic spending, resulting in more pessimistic expectations of future income generation in the private sector and higher risk premiums. The greater impact of the recession on Spanish institutions' asset portfolio quality was a consequence of their retail orientation, which placed greater relative importance on the loan portfolio. But above all it was a result of their overexposure to a real estate sector undergoing a severe process of adjustment.

Spanish banks were able to confront this second wave from an initially solid position. They had barely been affected by the first wave and, in addition to their strong earnings they had built up significant safety buffers in the boom years, thanks to the regulatory innovations introduced with the establishment of dynamic provisions. Nevertheless, these buffers gradually became exhausted as the recession dragged on and assets were increasingly eroded, while at the same time profitability levels declined. Hence, with a time lag and with certain specific characteristics, fragilities began to emerge that had built up in a segment of the financial system that had become exposed to larger risks during the period of rapid credit growth and that had made excessive investments in real estate, particularly in the property development sector, which suffered from high non-performing loan and bankruptcy rates. Although the problems were confined to a set of specific institutions (the savings banks), there was also a systemic aspect due to their influence on the reputation of the system as a whole and the danger that, if the effects of the crisis became prolonged and the economy entered into a sluggish growth phase with high unemployment, the scope might broaden.

During the economic boom, the savings banks' financial activities grew rapidly. Total credit to the various segments of the private non-banking sector quadrupled between 2001 and 2007. Most credit was channelled to the construction sector. Simultaneously they extended their operations beyond their original home provinces, opening branches across the country, which led them to accumulate significant excess capacity. Moreover, to finance their expansion, instead of increasing their own funds or their traditional customers' deposits, savings banks resorted to the wholesale international financial markets, issuing debt backed by mortgage instruments. Hence, in those rosy years the savings banks became highly exposed to real estate (construction and property development). A second weakness derived from their high degree of dependence on external finance. Any change in either would necessarily affect one or both sides of their balance sheets. To this ought to be added the special institutional weakness of the savings banks, due in particular to their peculiar legal status. The structure of savings banks as non-profit social undertakings (entities with the legal status of foundations) is complex and results in a model that lacks explicit owners and explicit equity capital and includes a variety of stakeholders with a multiplicity of objectives. All these factors combined affect their corporate governance system, on the one hand, and their capacity to raise equity by issuing shares on the other.

The financial difficulties made their appearance in March 2009 when, for the first time in nearly 15 years, the Banco de España had to rescue a savings bank. From that date on many other savings banks had to be placed under control, bailed out or forced to merge, while at the same time being restructured, all at a high cost for the public purse. Albeit rather belatedly, the financial authorities realised that they had to react to avoid a financial catastrophe, and they began to revise banking legislation and to implement measures not only to address the possible collapse of the financial system (in particular the savings banks sector) but also to restructure what was clearly an oversized financial system.

The strategy adopted by the Bank to address the financial crisis was to avert a chain of failures of institutions that may have led to the collapse of the entire banking system. By using private and public funds and by introducing legal and statutory reforms

the Bank aimed to restructure the weakest (insolvent) credit institutions before a systemic risk could spread to the market and among deposit holders. The alternative policy would have been to liquidate the institutions with solvency difficulties. Private depositors and taxpayers would have assumed the full cost of the crisis, since the Deposit Guarantee Schemes did not have enough resources to cover all short-term liabilities. The nationalisation of the banks and saving banks in trouble, a course of action followed in Germany, Great Britain and the Netherlands, would also have implied using a very substantial volume of public funds.

The first step was to create, in September 2009, a new resolution body with the name of Fund for the Orderly Restructuring of the Banking Sector (FROB, by its Spanish initials), which complemented the existing mechanism provided by the Deposit Guarantee Schemes. The new Fund had two main objectives: to facilitate integration processes among financial institutions, by providing technical assistance and also resources; and to seize control of institutions in difficulties, by taking over management and adopting the necessary support measures to maintain them afloat (capital contributions, loans, acquisition of assets or transfer of business to other institutions).

In 2010 a second set of regulatory measures affected the Banco de España's rules for credit risk provisions. The existing rules, established in 2004, were replaced and strengthened: the schedule for provisions was shortened and the provisions or cover for credit risk made stricter (25% must be provisioned immediately following a loan default, and credit risk must be fully provisioned after 12 months). The new rules also included a series of conditions on credit institutions' lending and risk-management policies, methods and procedures.

The specific problems of the savings banks and the concern about their performance and future led to the introduction of a dramatic regulatory change: the pivotal Royal Decree of July 2010 on savings banks' capital instruments, governing bodies and legal regime. The reform also included an optimal mechanism allowing savings banks to transfer their financial activity to instrumental banks.

In 2011 a Royal Decree introduced stricter measures to reinforce the solvency and liquidity of commercial banks and savings banks. Capital requirement ratios were increased, the composition of capital was redefined and new risk-based standards for provisioning of assets were adopted. A major regulatory change was the merger of the two existing Deposit Guarantee Schemes; the competences and responsibilities of the new Scheme were enlarged and its financial capacity was increased.

Further new regulatory measures were launched in 2012. In February, two Royal Decrees introduced a new round of changes to banks' capital requirements and credit risk provisions. A key development was the Memorandum of Understanding (MoU) signed between the Spanish authorities and the European Financial Stability Facility (now European Stability Mechanism) whereby Spain received financial assistance of €100 billion euros to cover losses and capitalise viable banking institutions. As a consequence of the MoU, Spain was required to introduce new changes in the law regulating the savings banks (yet to be approved by the Spanish government). The MoU also required that the objectives, procedures and operations of the FROB be reformed and that a new body be established, a joint public-private company to manage banks' toxic assets and non-performing loans. Thus the asset management company for assets arising from bank restructuring (Sareb, by its Spanish initials) was set up in December 2012 and was fully operational in 2013, buying and selling banks' assets (mortgages, securities, credits, loans).

The impact of the economic and financial crisis on the savings bank sector was devastating in terms of the number of institutions rescued by the government and the number of institutions remaining: from a total of 45 independent savings banks of various

sizes in 2010, the sector now comprises just 13 institutions (eleven groups and two small savings banks). As at December 2012, the number of branches had decreased by 20.5% to 18,409 and employment had been cut by 20%, with a loss of 24,313 jobs.

In addition, the nature of Spain's savings banks was radically altered. A key reform in November 2010 introduced new organisational models and changed their governance. With the new corporate formulas, savings banks may choose to exercise their financial activity directly, indirectly through a bank, or become a foundation and transfer their financial business to a bank. The reform also changed the composition of the board of directors, reducing the weight of public authorities, whether national, regional or municipal, and the presence of representatives of political parties and trade unions.

Although these changes have yet to prove their virtues, it is clear that the crisis did in fact dismantle the old savings bank system. Its present structure barely resembles the structure in place before the crisis. The main features of what five years ago defined a "savings bank" are no longer there. True, both the surviving savings banks and those that have been merged into larger groups retain their old and traditional denomination as "savings banks", but they are actually "banks". In fact the difference between commercial banks and savings banks has been blurred. The crisis has meant the liquidation (by transformation) of a financial sector with more than 150 years of history.

The restructuring process of the Spanish savings bank sector was complex, time-consuming and costly. At the dawn of the crisis in 2007 the Spanish authorities failed to recognise the magnitude of international events, and the contagion effects, and believed that the country's banking system was solid and well prepared and would avoid the bank failures that were occurring in the United States and Europe. It was thought that the construction boom would peter out slowly and gently, and the Spanish supervisor delayed recognising the impairment arising on the savings banks' books as the recession deepened. Instead of anticipating the evident solvency problems of many institutions, highly indebted in the wholesale external market and with a large volume of credit committed in the construction sector, they attributed the savings banks' difficulties to liquidity problems restricted to a few institutions. The forecast was plainly wrong. The problems were widespread and were related to solvency. Due to the delay in admitting the poor financial position of the savings banks, the cost of the rescue operations was staggering. The lesson to be learned is that the sooner the illness is admitted, the better for the patient. Acting sooner and faster in the first phases of the crisis, as in the United States and other European countries, would have been less costly. Supervision proved to be inadequate.

10 Conclusions

What are central banks? When and why were they founded? What function do they perform? Are they necessary? Defining a central bank is not an easy task.¹ Initially they were called banks of issue; the term central bank was not introduced until the late 19th century. The first central or issue banks were founded in extraordinary times, such as wartime, and established under the umbrella of governments owing to the financial advantages they could obtain as an institutional issuer. A second reason for the creation of central banks in Europe was the need to unify the chaotic monetary system. They acted in a way as nation builders. Once established they began to assume economic monetary policy objectives. At the macro level, managing monetary policy in the 19th century meant basically maintaining the gold standard, while in the last third of the 20th century the mandate was inflation targeting. At the micro level, preserving the stability of the financial system, as the lender of last resort, was key, a role that has necessarily implied assuming regulatory and supervisory responsibilities.

Most European central banks started out under private ownership and as ordinary commercial banks. It was the *metamorphosis* from their involvement in commercial banking to a non-competitive, non-profit maximising role that marked the emergence and development of proper central banking. This metamorphosis was complicated, it did not occur at the same time in all cases and for many issuers it took a rather long time. In some cases, the transformation came after nationalisation.²

The Banco de España is one of the oldest central banks, founded in 1782 with the name of Banco de San Carlos. It was established to support the market value of the government debt issued to finance the continental wars waged by the Spanish monarchy against England and France at the end of the 18th century. The Bank was chartered as a private joint-stock company and from its inception it enjoyed the privilege of issue of banknotes. In 1939 it was *de facto* nationalised and in 1962 it came *de jure* under the ownership of the State.

Three main historical forces have driven the history of the Banco de España. First wars, which meant temporary increases in government expenditure that the Bank, as the official or semi-official issuing institution, was called on to finance. A second force modelling the life of the Bank has been its links with the Treasury, because central banks have almost invariably been established by an act of government and designated as banker to the government. Even in peacetime the Bank has been called on to cover the fiscal needs of the government. Treasury policy and objectives have also shaped the historical trajectory of the Bank. There has always been permanent tension between its objectives as a private maximising commercial institution and its function as banker to the government. Thirdly, the Bank has been profoundly influenced by the development of ideas, theories and perceptions about its proper role, since institutions and their functions do not develop in a vacuum.

The monopoly of issue in 1874 did not mark the beginning of the Banco de España as a genuine central bank. At that time the Bank's main objective was profit maximisation. The convertibility of banknotes into gold or silver was seen as essential to guarantee the financial respectability of the Bank. Until nationalisation, monetary policy was not a major

1 There is a large body of literature in which these issues have been closely examined. Answers to some of these questions can be found in Bagehot (1873); Bordo *et al.* (2016); Capie *et al.* (1994); Conant (1896); Goodhart (1988); Siclos (2002); Singleton (2011); Smith (1936); Toniolo (1988). For Spain, Martín-Aceña and Feiertag (1999).

2 Goodhart (1988).

concern. Preserving the (domestic or international) value of the currency was considered a government responsibility. The fact that Spain was off the gold standard during its long time of domination was due, among other causes, to the non-collaborative stance of the Bank. The gold standard required the central bank to use its financial resources (gold and foreign exchange) and monetary instruments (interest rate) to maintain the stability of the exchange rate. The Bank never assumed that responsibility, either before 1914 or thereafter.

Nor was the stability of the financial system a responsibility that the Banco de España assumed while it was a private commercial company. Rivalry, more than cooperation, dominated the Bank's relationship with the commercial banking system. It was not until the beginning of the 20th century, at the earliest, that the Bank assumed the role of lender of last resort. At first, operations in this regard were undertaken under pressure from the government, and unwillingly. It was only in 1931, when the combination of the European banking crisis and the political crisis (the demise of the monarchy and the proclamation of the Second Republic) threatened the financial fabric of the country, that the Bank intervened as lender of last resort, jointly with the Treasury, to avoid a complete breakdown.

After its *de facto* nationalisation in 1939 and for more than three decades the Banco de España lost its autonomy and became an agent or branch of the Treasury. It changed its "profit maximising" objective for whatever goal the government decided: cheap and abundant money to foster economic growth, low interest rates to reduce the public debt burden, aid to rescue individual banks. On a few occasions, such as in the case of the 1959 Stabilisation Plan, monetary policy was used to combat inflation or other economic imbalances.

Despite its long history as a bank of issue, the Banco de España did not assume the role of a real central bank until late in the 20th century. From 1977 onward it regained its lost institutional autonomy and took full responsibility (the duties) for monetary policy. Indeed, the transformation of the Banco de España into a modern, fully-fledged central bank occurred just when it became part of the Eurosystem in 1999.

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FIGURES INDEX

Figure 2.1	The evolution of the market values of the «Vales Reales», 1780-1808	12
Figure 2.2	Banco de San Carlos: total assets, 1782-1829	13
Figure 2.3	Banco de San Carlos: <i>cédulas</i> (notes) in circulation, 1783-1803	13
Figure 3.1	Banco de San Fernando: assets, 1830-1850	18
Figure 3.2	Banco de San Fernando: liabilities, 1830-1855	19
Figure 3.3	Banco de San Fernando: net profit, 1830-1855	20
Figure 4.1	Banknotes in circulation, 1856-1873	24
Figure 4.2	Banco de España: assets, 1856-1874	26
Figure 4.3	Banco de España: liabilities, 1856-1873	26
Figure 4.4	Banco de España: profit and loss account, 1856-1873	26
Figure 5.1	Banco de España: assets, 1874-1914	33
Figure 5.2	Banco de España: liabilities, 1874-1914	33
Figure 5.3	Banco de España, 1874-1914	34
Figure 5.4	Exchange rate pesetas / pound sterling	37
Figure 6.1	Banco de España: total assets and liabilities, 1913-1935	46
Figure 6.2	Banco de España: assets, 1914-1935	46
Figure 6.3	Banco de España: liabilities, 1914-1935	46
Figure 7.1	Banco de España: total assets and banknotes in circulation, 1941-1962	54
Figure 7.2	Banco de España: main assets, 1941-1962	54
Figure 8.1	Gross domestic product and prices, 1962-1999	62
Figure 8.2	Gross domestic product and prices: annual variations, 1962-1999	63
Figure 9.1	Gross domestic product	68

TABLES INDEX

Table 5.1	Financial institutions: total assets, 1854-1913	35
Table 9.1	Growth of GDP, population and per capita income	67
Table 9.2	The macroeconomics of Spain, 2006-2012	68

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